LIBRARY
SUPREME COURT, U.S.

TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1957

No. 119

COMMISSIONER OF INTERNAL REVENUE,
PETITIONER,

vs.

NEIL SULLIVAN AND GRACE SULLIVAN; JAMES ROSS AND ANN ROSS; SAM MESI

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

PETITION FOR CERTIORARI FILED MAY 9, 1957

CERTIORARI GRANTED JUNE 17, 1957

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1957

No. 119

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

vs.

NEIL SULLIVAN AND GRACE SULLIVAN; JAMES ROSS AND ANN ROSS; SAM MESI

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

INDEX

	Original	Print
Proceedings in the United States Court of Appeals in the cases of Ross, et ux. v. Commissioner of Internal Revenue and Sullivan, et ux. v. Commissioner of Internal Revenue	1	1
Appendix to petitioners' brief consisting of proceedings before The Tax Court of the United States	1	1
Docket entries (Ross case)	1	1
Docket entries (Sullivan case)	3	3
Findings of fact and opinion (Ross and Sullivan cases)	5	5
Decision (Ross case)	19	17
Decision (Sullivan case)	20	17
Petition on review (Ross case)	21	18
Petition on review (Sullivan case)	22	19
Opinion, Schnackenberg, J.	24	20
Judgment (Ross case)	25	22
Judgment (Sullivan case)	26	23
Clerk's certificate (omitted in printing)	27	

	Original	Print
Record from The Tax Court of the United States in case of Sam Mesi v. Commissioner of Internal Revenue	1	24
Amended petition	1	24
Exhibit "A"—Deficiency Letter	4	26
Answer to amended petition	7	29
Stipulation of facts	9	31
Transcript of proceedings	14	37
Appearances	14	37
Statement by Mr. Slater	14	37
Statement by Mr. Newberger	15	38
Testimony of Philip C. Corrado—		
Direct	17	39
Cross	19	42
Redirect	20	43
Recross	21	44
Redirect	21	44
Testimony of Frank Maiola—		
Direct	23	46
Cross	26	49
Redirect	29	52
Recross	29	53
Redirect	31	55
Testimony of Anthony Jendryka—		
Direct	33	56
Cross	34	58
Testimony of Sam Mesi—		
Direct	36	60
Cross	41	65
Redirect	43	67
Colloquy between Court and counsel	45	69
Testimony of Norman Handelsman—		
Direct	48	72
Cross	52	77
Redirect	55	81
Findings of fact and opinion	56	81
Decision	69	95
Petition for review	69	95
Proceedings in the United States Court of Appeals for the Seventh Circuit	70	96
Statement of points	70	96
Notice of filing petition for review and statements of points; order enlarging time (omitted in printing)	73	
Opinion, Schnackenberg, J.	74	98
Judgment	77	100
Clerk's certificate (omitted in printing)	78	
Order allowing certiorari in Ross, Sullivan and Mesi cases	79	101

[fol. 1]

IN THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Docket No. 48593

JAMES ROSS AND ANN ROSS, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Appendix to Petitioners' Brief (Ross Case)

APPEARANCES:

For Petitioner: E. J. Blair, Esq.
For Respondent: George T. Donaghue, Jr., Esq.

DOCKET ENTRIES. (Ross Case)

1953

May 20—Petition received and filed. Taxpayer notified. Fee paid.
May 21—Copy of petition served on General Counsel.
May 20—Notice of appearance of E. J. Blair as counsel filed.
Jul. 6—Answer filed by General Counsel.
Jul. 6—Request for hearing in Chicago, Illinois filed by General Counsel.
Jul. 13—Notice issued placing proceeding on Chicago, Illinois calendar. Service of answer and request made.

1954

Jul. 6—Hearing set October 4, 1954, Chicago, Illinois.
Sept. 3—Motion for leave to file amendment to answer, amendment to answer lodged, filed by General Counsel. 9-7-54 Granted.
Sept. 8—Copy of motion and amendment to answer served on petitioner.
[fol. 2] Sept. 10—Motion to remove proceeding from the Chicago, Illinois calendar of 10-4-54 filed by petitioner. 9-10-54 Granted. 9-13-54 Served.

1954

Oct. 18—Reply to amendment to answer filed by taxpayer. Copy served.

Dec. 7—Hearing set January 24, 1955, Chicago, Illinois.

1955

Jan. 31—Hearing had before Judge Fisher, on the merits, on respondent's oral motion for exclusion of witnesses, no objection by petitioner, and on petitioner's motion to consolidate with docket 48594 for hearing, motions granted. Stipulation of facts filed at hearing. Briefs due 5/2/55. Replies due 6/1/55.

Feb. 10—Transcript of hearing 1/31/55 filed.

Apr. 26—Motion for extension of time to 6/16/55 to file brief filed by General Counsel. 4/26/55 Granted.

Apr. 29—Brief filed by taxpayer.

Jun. 16—Brief filed by General Counsel. Served.

Jun. 17—Copy of petitioner's brief served on General Counsel.

Jul. 12—Motion for extension to August 31, 1955, to file reply brief filed by taxpayer. 7/13/55 Granted. 7/14/55 Copy served.

Aug. 22—Reply brief filed by taxpayer. Copy served.

1956

Jan. 13—Memorandum findings of fact and opinion filed. Fisher, Judge. Decision will be entered under Rule 50. Copy served 1/13/56.

Mar. 13—Agreed computation for entry of decision filed.

Mar. 19—Decision entered, Judge Fisher, Div. 15.

Jun. 5—Petition for review by United States Court of Appeals, Seventh Circuit, filed by petitioner.

Jun. 5—Proof of service filed.

[fol. 3] Jun. 8—Statement of points with statement of service by mail thereon filed.

Jun. 8—Designation of record on review with statement of service by mail thereon filed.

Jul. 2—Order extending time for filing the record on review and docketing the petition for review to September 3, 1956, entered. Served 7/3/56.

Docket No. 48594.

NEIL SULLIVAN and GRACE SULLIVAN, Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

APPEARANCES:

For Petitioner: E. J. Blair, Esq.
For Respondent: George T. Donaghue, Jr., Esq.

DOCKET ENTRIES. (SULLIVAN CASE)

1953

May 20—Petition received and filed. Taxpayer notified. Fee paid.

May 21—Copy of petition served on General Counsel.

May 20—Notice of appearance of E. J. Blair as counsel filed.

Jul. 6—Answer filed by General Counsel.

Jul. 6—Request for hearing in Chicago, Illinois filed by General Counsel.

Jul. 9—Notice issued placing proceeding on Chicago, Illinois calendar. Service of answer and request made.

1954

Jul. 6—Hearing set October 4, 1954, Chicago, Illinois.

Sept. 3—Motion for leave to file amendment to answer, amendment to answer lodged, filed by General Counsel. 9 7 54 Granted.

[fol. 4] Sept. 8—Copy of motion and amendment to answer served on petitioner.

Sept. 10—Motion to remove proceeding from the Chicago, Illinois calendar of 10 4 54 filed by petitioner. 9 10 54 Granted. 9 13 54 Served.

Oct. 18—Reply to amendment to answer filed by Neil Sullivan, with death certificate of Grace Sullivan attached. Copy served.

Dec. 7—Hearing set January 24, 1955, Chicago, Illinois.

1955

Jan. 31—Hearing had before Judge Fisher, on the merits, on respondent's oral motion for exclusion of witnesses, no objection by petitioner, and on petitioner's motion to consolidate with docket 48593 for hearing, motions granted. Stipulation of facts filed at hearing. Briefs due 5 2 55. Replies due 6 1 55.

Feb. 10—Trafiscript of hearing 1 31 55 filed.

Apr. 26—Motion for extension of time to 6 16 55 to file brief filed by General Counsel. 4 26 55 Granted.

Apr. 29—Brief filed by taxpayer.

Jun. 16—Brief filed by General Counsel. Served.

Jun. 17—Copy of petitioner's brief served on General Counsel.

Jul. 12—Motion for extension to August 31, 1955, to file reply brief filed by taxpayer. 7 13 55 Granted. 7 14 55 Copy served.

Aug. 22—Reply brief filed by taxpayer. Copy served.

1956

Jan. 13—Memorandum findings of fact and opinion, filed. Fisher, Judge. Decision will be entered under Rule 50. Copy served 1 13 56.

Mar. 13—Agreed computation for entry of decision filed.

Mar. 19—Decision entered, Judge Fisher, Div. 15.

Jun. 5—Petition for review by United States Court of Appeals, Seventh Circuit, filed by petitioner.

[fol. 5] Jun. 5—Proof of service filed.

Jun. 8—Statement of points with statement of service by mail thereon filed.

Jun. 8—Designation of record on review with statement of service by mail thereon filed.

Jul. 2—Order extending time for filing the record on review and docketing the petition for review to September 3, 1956, entered. Served 7 3 56.

THE TAX COURT OF THE UNITED STATES

JAMES ROSS and ANN ROSS, Petitioners

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

NEIL SULLIVAN and GRACE SULLIVAN, Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket Nos. 48593, 48594

Findings of Fact and Opinion—January 13, 1956

During the taxable years 1948, 1949 and 1950, James Ross and Neil Sullivan were equal partners operating an illegal bookmaking business in Chicago, Illinois. In those years, the partnership return disclosed, respectively, gross profits of 6.86 per cent, 6.46 per cent and 5.56 per cent of total bets received. In his statutory notice of deficiency, respondent accepted the accuracy of the reported gross receipts and operating expenses, but disallowed the deduction of "pay outs" in excess of 86 per cent of amounts wagered. Respondent thereafter, in his amended answer, asserted additional deficiencies based upon the claim of illegality of payments for wages and rent in the conduct of a bookmaking business in the State of Illinois. Fraud was not alleged, and there was no evidence of fraud in the record. There was, however, no practical way for respondent to verify the correctness of petitioner's books and records by independent check, especially as to "pay outs" to winning bettors. *Held*.

[fol. 6] (a) Respondent's disallowance of a portion of claimed "pay outs" disapproved where calculated upon a ratio determined on the basis of data unrelated to petitioners' business or similar businesses.

(a) Respondent sustained in disallowing deductions for wages and rent paid in violation of Illinois law in the conduct of a bookmaking business.

(c) Penalties are allowed under sections 294(d)(1)(A) and 294 (d) (2) of the Internal Revenue Code of 1939. Penalties under 293(a) are disallowed.

E. J. Blair, Esq., for the petitioners.
George T. Donahue, Jr., Esq., for the respondent.

Memorandum Findings of Fact and Opinion

These are consolidated proceedings in which the respondent determined deficiencies in income taxes and penalties as follows:

Petitioners	Year	Tax	Deficiency	Sec. 293 (a) Penalty	Sec. 294 (d) (1) (A) Penalty	Sec. 294 (d) (2) Penalty
James Ross & Ann Ross	1948	Income	$13,407.14	$ 670.36	$1,593.28	$ 955.97
" "	1949	"	15,429.66	771.48	1,741.16	1,044.69
" "	1950	"	22,383.98	1,119.20	2,437.42	1,462.45
Neil Sullivan & Grace Sullivan	1948	Income	$13,254.02	$ 662.70	$1,562.13	$ 937.28
"	1949	"	15,255.36	762.77	1,709.99	1,025.99
"	1950	"	21,990.86	1,099.54	2,369.71	1,421.82

Respondent claimed increased deficiencies in the amendments to his answers as follows:

Petitioners	Year	Tax	Deficiency	Sec. 293 (a) Penalty	Sec. 294 (d) (1) (A)[1] Penalty	Sec. 294 (d) (2) Penalty
James Ross & Ann Ross	1948	Income	$ 7,403.52	$ 370.17	$ 740.36	$ 444.21
"	1949	"	8,726.25	436.32	872.60	523.57
"	1950	"	9,583.78	479.19	575.03	958.38
Neil Sullivan & Grace Sullivan	1948	Income	$ 7,387.68	$ 369.39	$ 738.77	$ 443.26
"	1949	"	8,694.64	434.73	869.45	521.68
"	1950	"	9,517.70	475.89	951.77	571.06

[1] These sections and the same sections on the previous page refer to the Internal Revenue Code of 1939.

[fol. 7] The issues presented involve:

(a) Disallowance by formula of a percentage of "pay outs" to winning bettors claimed to have been made by a partnership of bookmakers;

(b) Disallowance of deductions for wages and rent paid by bookmakers in violation of Illinois law;

(c) Application of penalties under sections 293(a); 294(d)(1)(A); and 294(d)(2) of the Internal Revenue Code of 1939.

Findings of Fact

The petitioners James Ross and Ann Ross are individuals with residence at 3520 Lake Shore Drive, Chicago, Illinois. Their joint Federal income tax returns for the calendar years 1948, 1949 and 1950 were timely filed with

the then collector of internal revenue for the first district of Illinois.

The petitioners Neil Sullivan and Grace Sullivan are individuals with residences at 5151 Kenmore Avenue, Chicago, Illinois. Their joint Federal income tax returns for the calendar years 1948, 1948 and 1950 were timely filed with the then collector of internal revenue for the first district of Illinois.

During the taxable years in question, petitioners Jimmy Ross and Neil Sullivan were equal partners engaged in the bookmaking business in Chicago, Illinois. Each of them invested a few hundred dollars as the original capital of the partnership. During the taxable years, the business of the partnership was conducted in various leased rooms on the upper floors of an hotel located at 411 South Wabash Avenue, in the central business district of Chicago. Customers of the partnership were usually directed to its place of business in the hotel by one of its employees or by other customers.

The partnership accepted bets from various individuals [fol. 8] and agreed to pay the bettor if he won his bet, such odds as were shown by the pari-mutuel machines of the various race tracks located in different parts of the country, with the limitation that in no event would it pay more than $30 for $1.00, in respect of "win"; $12 for $1.00 in respect of "place", and $6.00 for $1.00 in respect of "show". To win a "win" bet the horse wagered on must come in first; to win a "place" bet the horse wagered on must come in first or second; and to win a "show" bet the horse wagered on must come in first, second or third. To win a daily double bet, the bettor must select in advance the winning horses in two races at a particular track, usually the first and second races. Parlay bets are similar to daily double wagers, except they may be made to win, place or show and may be made on two or more horses at the same or different tracks. Like daily double bets, the horses must be selected in advance, and all must win, place or show, depending on how they were bet to finish.

A "scratch" occurs when a horse entered in a race is withdrawn shortly before the running of the race. "Scratches" on which the partnership had accepted wagers did not occur in substantial number during the [illegible]

a year. In the case of a "scratch", the wager was returned to the bettor, and the repayment was recorded on the partnership records as an "out" in the same amount as the wager.

The bets placed by patrons of the partnership were recorded on printed forms known as safety tickets, the originals of which were given to the patrons, and the carbon copies of which were retained by the partnership. These safety tickets were printed in duplicate in books of ten pages with twenty tickets to a page, each ticket bearing a printed number. On these safety tickets in the spaces provided for the purpose, was written the information containing the number of the horse, the kind of the bet, such as at [fol. 9] "win," "place" or "show," et cetera, and the amount of the bet.

A large cardboard sheet, commonly called a hard card, for each track was hung on the wall in the partnership's place of business each day. The hard card showed the entries for the day, the jockeys and probable odds. Each horse was shown by name and number and the number corresponded to the number written in on the safety ticket when a bet was made on the horse.

The partnership subscribed to a wire service which gave information over a loud speaker such as the time when the race commenced, the progress of the race until it ended, the result, and then the odds payable at the track to the winners of win, place and show bets on the basis of $2.00 bets. A winner was required to present the original ticket to collect his wager. When a winner presented the original, it was checked against the carbon copy of the partnership, and if the carbon copy showed it to be a winning ticket the notation of the amount payable was entered thereon and the bettor was paid according to the amount of the wager and the odds at the track at which the horse ran, subject to the limitations in amount set forth above.

At the close of each day the partnership totaled the sums shown as wagered, i. e., "ins," and the sums shown as payable to winning wagerers, i. e., "outs," as they appeared on its records. These totals, together with its various expenses, were entered on a daily summary sheet. This daily summary sheet was sent to the accountant employed by the partnership.

The partnership did not preserve the original safety tickets presented by winning patrons for the years in question. It did preserve the carbon copies of the safety tickets for each day of operation and the daily summary sheets which were made from these carbon copies. Each day the partnership placed within the folded hard cards the carbon [fol. 10] copies of the safety tickets, together with adding machine tapes showing the total "ins" and the "outs." The records thus prepared and preserved were given to the accountant for the partnership, and from these he prepared monthly summary sheets. The monthly summary sheets were recapitulated and served as the basis for the preparation of the partnership's income tax returns for the years involved herein. The returns were prepared on the cash receipts and disbursements basis.

During the taxable years, equal cash withdrawals were made by petitioners from the partnership sometimes as often as twice a week but not less than once a month. These cash withdrawals were not recorded on the books and the records of the partnership.

The partnership books and records included a cash account, and capital accounts for the partners. No bookkeeping record was made of cash withdrawals by the partners. As a result, neither the cash account nor the capital accounts were accurate during the years in question, since they were not reduced by such withdrawals. The accountant merely used them on his own initiative as in the nature of closing accounts to keep the double entry books in balance. While the accounting procedures so used were not correct or proper, they did not have the effect of distorting income. The only practical effect was to show a continuing accumulation of cash and capital which did not in fact exist. The accountant did not know the amount of cash withdrawals made by petitioners, or the actual amount of cash in the partnership at any particular time.

The accountant did not make any test to ascertain whether any of the "outs" shown on the partnership's records for the years involved were, in fact, amounts paid to winning bettors. He occasionally verified the arithmetical accuracy of the daily summary sheets. He was not shown the daily cash reconciliations.

[fol. 11] On frequent occasions during the taxable years, the place of business of the partnership was raided by the

police. With the exception of Sundays and holidays, the partnership conducted its operations on all days during the taxable years although it stopped business before its regular closing hour on those days on which its place of business was raided by the police. It changed its rooms in the hotel from time to time because of such raids. A number of petitioners' employees were arrested as a result of said raids, but neither of the partners was ever arrested.

At the time of examination, the revenue agent found that some of the pads of safety tickets were missing, and that the consecutive order of pads was not complete. He did not make any effort to ascertain how many more there might have been. He did verify, however, that the income on the partnership returns checked with the records furnished him. The pads were not necessarily used in alphabetical or numerical sequences.

Petitioners did not identify any of the individuals to whom the partnership paid winning bets during the taxable years, although they were questioned in this regard during the revenue agent's examination and at the hearing.

In its returns, the partnership reported total "ins" and "outs," losses from "hedging" and gross profit for the years 1948, 1949 and 1950, as follows:

Year	Total "Ins"	Total "Outs" and and Losses from "Hedging"	Gross Profit	Percentage
1948	$ 944,295.55	$ 879,505.60	$64,789.95	6.86
1949	1,030,671.00	964,098.00	66,573.00	6.46
1950	1,197,365.10	1,130,789.00	66,576.10	5.56

Of the amount claimed in the partnership returns as paid out on winning wagers, the respondent disallowed the following:

Year	Disallowed
1948	$ 67,411.42
1949	77,660.94
1950	101,055.01

[Fol. 12] The disallowance was based upon the assumption that the "outs" approximated 86 per cent of the amounts bet, and the "outs" claimed on the partnership returns for the years in question in excess of such percentage were disallowed on this theory.

At pari-mutuel racing tracks throughout the United States 10 per cent to 17 per cent of all bets placed is deducted for the racing association and the taxing authorities, and the remaining 90 per cent to 83 per cent is distributed to winning bettors. Under the laws of Illinois for the years 1948, 1949 and 1950, approximately 13 per cent of every dollar bet at the tracks was deducted from the mutuel pool, part of which was retained by the racing association and part of which was paid to the State. In addition to the part retained by the racing association, it also received and retained breakage to the dime, which amounts to approximately 1½ per cent of the totals wagered. The remaining 85½ per cent was distributed to the winning bettors.

The partnership in the conduct of its business of bookmaking paid total wages to its six or seven employees and deducted them in its returns for the taxable years as follows:

Year	Wages
1948	$18,950.00
1949	22,935.00
1950	23,390.00

The services of the employees for these wages were performed in the operation of the bookmaking business of the partnership, including the recording of bets.

The partnership paid total rent to the lessor of the various hotel rooms in which it conducted its business of bookmaking and deducted the rent in its returns for the taxable years as follows:

Year	Rent
1948	$8,735.00
1949	3,200.00
1950	9,215.00

[fol. 134] The lessor knowingly permitted these rooms to be used for the purposes of bookmaking.

The acts performed by the employees of the partnership and the lessor in return for the wages received by the former, and the rent received by the latter, constituted violations of section 336 of the Criminal Code of the State of Illinois. The payment of said wages and rent constituted a violation of section 582 of said Code.

Respondent determined penalties against petitioners for each of the years in question for failure to file declarations of estimated tax. The amounts of gross income disclosed on the returns filed by petitioners for said years were sufficient in themselves to have required petitioners to file declarations of estimated tax under the provisions of section 58 of the Internal Revenue Code of 1939. Petitioners do not deny that they failed to file such declarations of estimated tax and have presented no evidence to show that such failure was due to reasonable cause and not to wilful neglect.

Eighty per centum of the taxes of petitioners for each of the years in question was in excess of the estimated tax (which was zero) for each of said years.

No part of the deficiency in any of the years here in question was due to negligence or intentional disregard of rules and regulations on the part of petitioners, or any of them.

Opinion

Fisher, *Judge:* This is another bookmaker case, quite similar, in many respects, to *Sam Mesi*, 25 T.C. (filed December 16, 1955).

The first issue involves the disallowance by respondent of all "outs" in excess of 86 per cent of the amounts bet. The statutory notice of deficiency does not contest the accuracy of the gross receipts or the operating expenses, and does not purport to disallow any particular "outs." The [fol. 14] disallowance of "outs" in excess of the percentage above referred to was based on a formula applied because, as the investigation agent testified, in rather vague language, "the industry generally should figure on paying out about 86 per cent—$86 for every hundred dollars bet * * *." It is evident that this figure was based substantially upon the fact that lawful pari-mutuel tracks in Illinois in 1948, 1949 and 1950 distributed to winning bettors 85½ per cent of amounts bet. (In the United States generally, pari-mutuel race tracks distributed from 83 per cent to 90 per cent to winning bettors.) As we recognized in *Sam Mesi*, *supra*, and have held in numerous other cases, there is no relation between the amounts distributed to winners by mutuel tracks (where the track, for practical purposes, is only a stakeholder) and the gross profits of a bookmaker

who bets against the customer. It is apparent, therefore, that the formula on which respondent relies is here inapplicable.

Respondent's statutory notice determines no fraud, mathematical inaccuracy, or specific discrepancy with respect to the "outs." This position is, in substance, that there is no practical way in which he can verify by audit the amount of the "outs," because petitioners did not require receipts for "outs" or obtain the names and addresses of winning bettors. We doubt whether such data would have been of material assistance in an audit because it is unlikely that true names and addresses would have been furnished to bookmakers. We recognize the difficulty of an effective audit, however, but we do not think the solution lies in the effort to apply an unrealistic formula. Other techniques, such as the determination of income by the net worth increase method, have been developed which have been quite effective in ferreting out unreported income where the usual auditing methods are inadequate. No such method has been availed of in the instant case.

[fol. 15] The investigating agent had access to the "hard cards" and carbons of "safety tickets." It is true that he testified that some pads of "safety tickets" were missing, and some not in consecutive order but he made no effort to find out if they were in any other place, and did not indicate the extent to which they were missing or misplaced. He did not suggest that there was any indication that any of them had been destroyed. Moreover, the ledger sheets showing the posting of monthly totals were furnished to him. He testified that he verified that "the partnership returns jibed directly with the records furnished me."

It is clear from the record that, assuming that the entries were honestly made, the books and records were adequate to reflect income for income tax purposes. It is true that there was no practical way to verify specific "outs." Moreover, we naturally approach with suspicion any issue involving the conduct of an illegal business. Nevertheless, no fraud was alleged. The test of net worth increase was not used. Falsification of the books and records would have required collusion on the part of employees as well as the partners. No specific inaccuracies or falsifications were discovered with respect to such "outs" and no specific "outs" were disallowed.

Under the circumstances, we cannot arbitrarily apply an inapplicable formula. Respondent has made no determination disallowing specific "outs" and we find no basis for determining or measuring a deficiency by disallowing a portion thereof. By the same token, we find no support in the record for application of the rule of *Cohan* v. *Commissioner*, 39 F. 2d 540 (C. A. 2, 1930) to this issue, as urged by respondent. In fine, there is nothing in the case which warrants us in disregarding the "outs" as established by petitioners' books and records.

The next issue concerns additional deficiencies proposed [fol. 16] by respondent in his amended answers attributable to disallowance of wages and rent paid by the partnership. Respondent's contention is that such payments violated Illinois law, and are not allowable because contrary to public policy.

Section 336 of the Criminal Code of the State of Illinois provides as follows:

Illinois Revised Statutes 1945 (Burdette Smith).

> 336. * * * That any person who keeps any room, shed, tenement, tent, booth or building, or any part thereof, or who occupies any place upon any public or private grounds within this State with any book, instrument or device for the purpose of recording or registering bets or wagers, or of selling pools, or any person who records or registers bets or wagers, or sells pools upon the result of any trial or contest of skill, speed or power of endurance of man or beast, or upon the result of any political nomination, appointment or election, or being the owner, lessee or occupant of any room, shed, tenement, tent, booth or building, or part thereof, knowingly permits the same to be used or occupied for any of these purposes, or therein keeps, exhibits or employs any device or apparatus for the purpose of recording or registering such bets or wagers, or selling of such pools, or becomes the custodian or depository for hire or privilege, of any money, property, or thing of value staked, wagered or pledged upon any such result, shall be punishable by imprisonment in the county jail for a period not longer than one year, or by fine not exceeding $2,000 or both.

> Provided, however, that the provisions of this act shall not apply to the actual enclosure of fair or race track associations that are incorporated under the laws of this state, during the actual time of the meetings of said associations, or within twenty-four hours before any such meetings.

[fol. 17] In addition, section 582 of the Criminal Code of the State of Illinois provides:

> Illinois Revised Statutes 1945 (Burdette Smith).
>
> 582. * * * § 2. An accessory is he who stands by, and aids, abets or assists, or who not being present, aiding, abetting or assisting, hath advised, encouraged, aided, or abetted the perpetration of the crime. He who thus aids, abets, assists, advises or encourages, shall be considered as principal, and punished accordingly.

With respect to wages, the specific issue was before us in *Sam Mesi*, *supra*, which is here controlling. After a full discussion of the applicable principles and decisions relating to the disallowance of illegal expenses, we said, in part:

> Pursuant to these sections of the Criminal Code of the State of Illinois, the payment of the wages in question in and of itself constituted an illegal act. The wages paid by petitioner were paid to procure the direct aid of others in the perpetration of an illegal act, namely, the operation of a bookmaking establishment. Certainly, it would be a clear violation of public policy to permit the deduction of an expenditure, the making of which constitutes an illegal act.

While we had no occasion to consider the question of rents in the *Mesi* case, we think that the principles there announced are equally applicable to rental payments on the facts presented in the instant case. It is clear that the lessor as well as the lessees were fully aware that an illegal bookmaking enterprise was being carried on upon the premises, and that both the payment and receipt of rentals were in violation of sections 326 and 582 of the Illinois Revised Statutes cited above.

We hold, therefore, that the deduction of wages and rents must be disallowed.

[fol. 18] Respondent determined penalties for each of the years involved under section 294(d)(1)(A) for failure to make and file a declaration of estimated tax. The gross income reported on the returns filed by petitioners for each of the years in question was alone clearly sufficient to require the filing of such declarations under the provisions of section 58. Since petitioners do not deny that they failed to file such declarations, and since they offer no evidence to show that such failure was due to reasonable cause and not to wilful neglect, it is clear that such penalties will apply, the amount to be determined in a computation under Rule 50.

A penalty for each year was likewise determined under section 294(d)(2) for substantial understatement of estimated tax. Since we have found as a fact that 80 per centum of the taxes of petitioners for each of the years in question was in excess of the estimated tax (which latter was zero, since no estimate was filed) it is again apparent that such penalties will apply. *G. E. Fuller* (1953) 20 T. C. 308, 316, affd. (C. A. 10) 213 F. 2d 102. The amount thereof will likewise be determined under Rule 50.

We take a different view, however, with respect to penalties under section 293(a). Here, penalties may be applied only if there is a deficiency, and if any part of such deficiency is due to negligence or intentional disregard of rules and regulations. Since we have held that the respondent erred in disallowing any part of the "rents" deducted by petitioners, no part of any deficiencies are attributable thereto. While we have sustained respondent in the disallowance of deductions for wages and rent, we think that the state of the law on these issues was unsettled prior to our Opinion in *Sam Mesi, supra*, which was not published until December 16, 1955, long after the returns in issue were filed and the deductions taken. We think it is [fol. 19] clear, therefore, that the resultant deficiencies are not to be regarded as due to any negligence or intentional disregard of rules and regulations by petitioners. We hold, therefore, that penalties under section 293(a) do not here apply.

Decisions will be entered under Rule 50.

THE TAX COURT OF THE UNITED STATES

Washington.

Docket No. 48593.

JAMES ROSS AND ANN ROSS, Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

DECISION (ROSS CASE)—Entered March 19, 1956

Pursuant to the Memorandum Findings of Fact and Opinion filed January 13, 1956, the parties on March 13, 1956, having filed an agreed computation of the tax, it is

Ordered and Decided: There are deficiencies in income tax and penalties as follows:

Year	Deficiency	Sec. 293 (a) Penalty	Sec. 294 (d) (1) (A) Penalty	Sec. 294 (d) (2) Penalty
1948	$4,362.18	None	$676.92	$413.27
1949	4,886.44	None	618.15	412.09
1950	5,100.10	None	638.14	425.42

Entered Mar. 19, 1956.

(Seal) Morton P. Fisher, Judge.

[fol. 20] THE TAX COURT OF THE UNITED STATES

Washington.

Docket No. 48594.

NEIL SULLIVAN AND GRACE SULLIVAN, Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

DECISION (SULLIVAN CASE)—Entered March 19, 1956

Pursuant to the Memorandum Findings of Fact and Opinion filed January 13, 1956, the parties on March 13, 1956, having filed an agreed computation of the tax, it is

Ordered and Decided: There are deficiencies in income tax and penalties as follows:

Year	Deficiency	Sec. 293 (a) Penalty	Sec. 294 (d) (1) (A) Penalty	Sec. 294 (d) (2) Penalty
1948	$4,293.54	None	$[illegible]	$899.65
1949	4,796.68	None	597.71	398.47
1950	4,914.52	None	595.87	397.25

Entered Mar. 19, 1956.

(Seal) Morton P. Fisher, Judge.

[fol. 21] United States Court of Appeals for the Seventh Circuit

T. C. Docket No. 48593

James Ross and Ann Ross, Petitioners on Review,

vs.

Commissioner of Internal Revenue, Respondent on Review

Petition of Review (Ross Case)—Filed June 5, 1956

The petitioners, James Ross and Ann Ross, hereby petition for a review by the United States Court of Appeals for the Seventh Circuit of that part of the decision entered by The Tax Court of the United States on March 19, 1956, in T. C. Docket No. 48593, ordering and deciding that there are deficiencies in income tax and penalties under the provisions of the Internal Revenue Code of 1939 for the taxable years 1948, 1949 and 1950, as follows:

Year	Deficiency	Sec. 294 (d) (1) (A) Penalty	Sec. 294 (d) (2) Penalty
1948	$4,362.18	$619.92	$413.27
1949	4,886.44	618.15	412.09
1950	5,100.10	638.13	425.42

Petitioners, James Ross and Ann Ross, were husband and wife during the years involved in this proceeding and filed their joint income tax returns with the Collector of Internal Revenue for the First District of Illinois, whose office is located within the jurisdiction of the United States Court of Appeals for the Seventh Circuit.

The above named petitioners filed this petition pursuant to the provisions of Sections 7482 and 7483 of the Internal [fol. 22] Revenue Code of 1954. This controversy involves Federal income taxes for the years 1948, 1949 and 1950.

E. J. Blair, 77 W. Washington Street, Chicago 2, Illinois, Counsel for Petitioners.

United States Court of Appeals for the Seventh Circuit

T. C. Docket No. 48594

Neil Sullivan and Grace Sullivan, Petitioners on Review,

vs.

Commissioner of Internal Revenue, Respondent on Review

Petition of Review (Sullivan Case)—Filed June 5, 1956

The petitioners, Neil Sullivan and Grace Sullivan hereby petition for a review by the United States Court of Appeals for the Seventh Circuit of that part of the decision entered by The Tax Court of the United States on March 19, 1956, in T. C. Docket No. 48594, ordering and deciding that there are deficiencies in income tax and penalties under the provisions of the Internal Revenue Code of 1939 for the taxable years 1948, 1949 and 1950, as follows:

Year	Deficiency	Sec. 294 (d) (1) (A) Penalty	Sec. 294 (d)-(2) Penalty
1948	$4,293.54	$599.47	$399.65
1949	4,796.68	597.71	398.47
1950	4,914.52	595.87	397.25

Petitioners, Neil Sullivan and Grace Sullivan, were husband and wife during the years involved in this proceeding [fol. 23] and filed their joint income tax returns with the Collector of Internal Revenue for the First District of Illinois, whose office is located within the jurisdiction of the United States Court of Appeals for the Seventh Circuit.

The above named petitioners file this petition pursuant to the provisions of Sections 7482 and 7483 of the Internal

Revenue Code of 1954. This controversy involves Federal income taxes for the years 1948, 1949 and 1950.

E. J. Blair, 77 W. Washington Street, Chicago 2, Illinois, Counsel for Petitioners.

[fol. 24] In the United States Court of Appeals for the Seventh Circuit, September Term, 1956, January Session, 1957

No. 11841

Neil Sullivan and Grace Sullivan, Petitioners,

vs.

Commissioner of Internal Revenue, Respondent

No. 11842

James Ross and Ann Ross, Petitioners,

vs.

Commissioner of Internal Revenue, Respondent

Petitions for Review of Decisions of the Tax Court of the United States

Decision—February 13, 1957

Before Lindley, Swaim and Schnackenberg, Circuit Judges

Schnackenberg, *Circuit Judge*. Petitioners seek a review[1] of that part of decisions entered by the Tax Court of the United States which determined deficiencies in their income taxes for the years 1948, 1949, and 1950, and imposed penalties therefor. The only contested issue in the cases is whether or not petitioners may deduct for income

[1] These cases came from the Tax Court on a consolidated record.

tax purposes unlawful payments of wages and rent in connection with the unlawful operation in Illinois of a bookmaking establishment by petitioners Neil Sullivan and James Ross.

This legal issue was presented, argued and decided by this court in *Commissioner of Internal Revenue v. Doyle*, 231 F.2d 635, where the Commissioner himself stated the question there presented to us for decision, in this language: Whether expenses for rent and wages incurred in the operation of an illegal gambling business are themselves contrary to a sharply defined and declared public policy of the state of Illinois and hence are not deductible for income tax purposes, within the meaning of sec. 23(a), Internal Revenue Code of 1939. In our opinion, we accepted and decided the question as thus stated. In this case, the Commissioner states the contested issue thus: Whether a taxpayer may deduct for income tax purposes payments of rent and wages which were made in violation of criminal statutes of the state of Illinois.[2] It does not appear that the Commissioner applied to the United States Supreme Court for *certiorari* to review our decision in the *Doyle* case. It does appear that, before a single judge of the Tax Court who tried the case at bar the Commissioner contended and now contends that the holding of this court in the *Doyle* case should not be followed. If the Commissioner feels that the decision in the *Doyle* case was wrong he should have, by application for *certiorari*, afforded the Supreme Court an opportunity to pass upon his contentions. Lacking such a decision by the highest court, a decision by one judge of the Tax Court, which, in effect, overrules a decision of the court of appeals in the circuit in which both cases arose, is not consonant with the responsibilities of the respective tribunals involved. To the same effect is *Stacey Mfg. Co. v. Commissioner of Internal Revenue*, 237 F.2d 665.

---

[2] In the *Doyle* case, the Commissioner relied on only the following statutes of the state of Illinois: ¶¶ 139, 140, 336 and 582, chapter 38 (Criminal Code) Illinois Revised Statutes, 1945. He relies upon the same statutes in the case at bar.

Our opinion in the *Doyle* case neither expressly treated, nor by any possible inference can be construed as treating, the wages and rent paid by the taxpayer as "legitimate" expenses. The word "legitimate", upon which the Commissioner now relies in an attempt to distinguish the *Doyle* case, was used by the Tax Court in its decision in the *Doyle* case, but not by us. We made it clear, at 636, that sec. 23(a),[3] in setting forth what trade or business expenses are to be deducted from gross income in computing net income, makes no distinction between *lawful* and *unlawful* disbursements.

On the authority of the *Doyle* holding, to which we adhere, the decision of the Tax Court is reversed and the cause is remanded[4] for the sole purpose of a redetermination of the penalties, if any, assessable solely on the basis of income reported by petitioners in their returns.

Reversed and Remanded.

[fol. 25] UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

No. 11842

JAMES ROSS and ANN ROSS, Petitioners,

vs.

COMMISSIONERS OF INTERNAL REVENUE, Respondent

Petition for Review of a Decision of the Tax Court of the United States

JUDGMENT (Ross Case)—February 13, 1957

This cause came on to be heard on the transcript of the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by

---

[3] 26 U.S.C.A. § 23(a).

[4] 26 U.S.C.A. § 7482.

this Court that the decision of the Tax Court of the United States entered in this cause on March 19, 1956 be, and the same is hereby, REVERSED, and that this cause be, and the same is hereby REMANDED to the said Tax Court of the United States for the sole purpose of a redetermination of the penalties, if any, assessable solely on the basis of income reported by petitioners in their returns, in accordance with the opinion of this Court filed this day.

[fol. 26] UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

No. 11841

NEIL SULLIVAN and GRACE SULLIVAN, Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Petition for Review of a Decision of the Tax Court of the United States

JUDGMENT (SULLIVAN CASE)—February 13, 1957

This cause came on to be heard on the transcript of the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this Court that the decision of the Tax Court of the United States entered in this cause on March 19, 1956 be, and the same is hereby, REVERSED, and that this cause be, and the same is hereby, REMANDED to the said Tax Court of the United States for the sole purpose of a redetermination of the penalties, if any, assessable solely on the basis of income reported by petitioners in their returns, in accordance with the opinion of this Court filed this day.

[fol. 27] Clerk's Certificate to foregoing Transcript (omitted in printing).

[fol. 1] The Tax Court of the United States

Docket No. 50868

Sam Mesi, Petitioner,

vs.

Commissioner of Internal Revenue, Respondent

Amended Petition (Mesi Case)—Filed January 4, 1954

The above-named Petitioner, in conformity with the notice of hearing on motion to dismiss, dated December 14, 1953, hereby amends the petition heretofore filed by him, and asks that this amended petition stand in the place and stead of the original petition. The Petitioner hereby petitions for a re-determination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (Bureau symbols ADC-Ap:CHI Chi:JGA), dated June 29, 1953, and as a basis of this proceeding alleges as follows:

1. The Petitioner is an individual residing at 1163 West Grand Avenue, in Chicago, Illinois. The return for the period here involved was filed with the Collector for the First District of Illinois.

2. The notice of deficiency (a copy of which is attached and marked Exhibit "A"), was mailed to the Petitioner on June 29, 1953.

3. The tax in controversy is income tax for the calendar year 1946, and the deficiency asserted amounts to $41,555.81.

4. The determination of tax set forth in the said notice of deficiency is based on the following errors:

(A) Increase in gross receipts (gross profit) from taxpayer's business in the amount of $48,010.41 for the year 1946.

(B) Disallowance of wages and compensation paid to taxpayer's employees representing ordinary and necessary expense in the conduct of his business in the amount of $14,563.84 for the year 1946.

The facts upon which the Petitioner relies as the basis of this proceeding are as follows:

[fol. 2]

A

1. During the year 1946 Petitioner was engaged in the business of operating a handbook and derived earnings from the placing of wagers with him in the city of Chicago, State of Illinois.

2. The total gross receipts derived by taxpayer from the operations of his gaming establishments were as follows:

Gaming receipts	$793,287.50
Gaming disbursements	750,069.85
Gross Receipts (or Gross Profit)	$ 43,217.65

3. The gross receipts and gross profit from taxpayer's gaming business as stated above were included by Petitioner in his income tax return for the year 1944.

4. Respondent increased Petitioner's gross receipts (actually gross profit) from said gaming business in the amount of $48,010.41, and alleged in his notice of deficiency that the method used in determining that taxpayer had derived additional gross receipts was "on the basis of information on file in the Bureau".

5. The Respondent failed to indicate any recognized accounting method that was employed in determining the alleged increase in gross receipts as asserted in his notice of deficiency. It is herewith alleged that the same is arbitrary and capricious, and that failing to show that the same was arrived at by some recognized and approved accounting method of determining said increase in Petitioner's income, the same should be stricken from the Commissioner's notice of deficiency.

6. In the alternative, it is herewith asserted that taxpayer's return as filed fully accounted for all gross receipts and gross profit from his gaming business, and that the Respondent erred in arbitrarily increasing taxpayer's gross receipts (gross profit) from his business.

B

1. During the year 1946, in connection with the operations of the said gaming business, Petitioner incurred and paid wages, to employees who aided him directly in the handling of gaming wagers, in the sum of $14,563.84.

[fol. 3] 2. The expenses incurred were ordinary and necessary and incurred directly in connection with the operations of Petitioner's gaming business.

3. Petitioner deducted the amount shown above as wages from his income tax return for the year, 1946.

4. Respondent disallowed the said amount deducted as "wages" as contrary to public policy.

5. Within the meaning and intent of Sec. 23(a) of the Internal Revenue Code and the applicable decisions of this Court and the United States Supreme Court, amounts paid directly to employees who performed direct services, even in the operations of an illegal undertaking, are nevertheless ordinary and necessary deductions, and are not contrary to public policy. The Respondent erred in disallowing the said deduction.

Wherefore, Petitioner prays that this Court may hear the proceeding and correct the assigned errors.

(S.) Howard R. Slater, Attorney for Petitioner, 77 West Washington Street, Chicago 2, Illinois, FRanklin 2-6365.

Duly sworn to by Sam Mosi (Jurat omitted in printing).

[fol. 4] Exhibit A to Amended Petition

U. S. Treasury Department

Office of the District Commissioner, Internal Revenue Service

June 29, 1953

In Replying Refer To:
Assistant District Commissioner, Appellate
Chicago District
Post Office Box FF
Chicago 90, Illinois
ADC:App:CHI
Chi:JGA
Mr. Sam Mosi
1163 West Grand Avenue
Chicago 22, Illinois

Sir:

You are advised that the determination of your income tax liability for the taxable year ended December 31, 1946

discloses a deficiency of $41,555.81 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws notice is hereby given of the deficiency mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United States, at its principal address, Washington 4, D. C., for a redetermination of the deficiency. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday or legal holiday in the District of Columbia in which event that day is not counted as the 90th day. Otherwise Saturdays, Sundays and legal holidays are to be counted in computing the 90-day period.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to: Assistant District Commissioner, Appellate Division, Chicago District, Post Office Box FF, Chicago 90, Illinois. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the deficiency [fol. 5] and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is earlier.

Very truly yours, T. Coleman Andrews, Commissioner of Internal Revenue, by Clarence W. Sebring, Assistant District Commissioner, Appellate.

Enclosures:

Statement
Form 1276
Agreement Form 870.

Statement

Sam Mesi
1163 West Grand Avenue
Chicago 22, Illinois

Tax Liability for the Taxable Year Ended December 31, 1946.

	Deficiency
Income Tax	$41,555.81

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated June 23, 1950; to your protest dated October 26, 1950 and to the statements made at the conferences held on November 30, 1950 and April 3, 1952.

A copy of this letter and statement have been mailed to your representative, Mr. Philip C. Corrado, 77 W. Washington Street, Chicago 2, Illinois, in accordance with the power of attorney executed by you.

Adjustments to Net Income

Net income as disclosed by original return	$16,898.50
Additional income and unallowable deductions:	
(a) Partnership income	310.92
(b) Additional gross receipts from business	48,010.41
(c) Business deductions	14,563.84
Net income as adjusted	$79,893.67

[fol. 6] Explanation of Adjustments

(a) You reported the following partnership income in an amended return filed on September 15, 1947, not included in income on the return as originally filed:

Sarfie Mesi and Bernard Petrone	$166.80
Sam Mesi and Géo. Bravos	144.12
Total partnership income	$310.92

(b) The excess of gaming receipts over gaming disbursements, or gross receipts reported by you in your income tax return for the taxable year 1946 in the amount of $43,217.65 has been increased by $48,010.41 on the basis of information on file in the Bureau and in accordance with the provisions of sections 22(a) and 41, Internal Revenue Code.

(c) The deduction for $14,563.84 explained as "Wages" has been disallowed as contrary to public policy, and as representing amounts paid to others to engage in an illegal undertaking contrary to the statutes of the State of Illinois. Accordingly, they are not ordinary and necessary business

expenses within the meaning and intent of section 23(a), Internal Revenue Code.

Computation of Tax

(Alternative Method)

Net income as adjusted		$79,783.67
Less: Excess of net long-term capital gain over net short-term capital loss		750.00
Ordinary net income		$79,033.67
Less: Exemption		500.00
Income subject to tentative tax		$78,533.67
Combined tentative normal tax and surtax on $78,533.67		$49,032.27
Tax reduction—5%		2,451.61
Partial Tax		$46,580.66
Add: 50% of $750.00		375.00
Income Tax liability		$46,955.66
Income tax liability disclosed by return	$5,129.29	
Additional assessment Aug. 11, 1950 List, Acct. No. 519042	270.56	$ 5,399.85
Deficiency in income tax		$41,555.81

[fol. 7] THE TAX COURT OF THE UNITED STATES

ANSWER TO AMENDED PETITION—Filed February 26, 1954

Comes now the Commission of Internal Revenue, by his attorney, Daniel A. Taylor, Chief Counsel, Internal Revenue Service, and for answer to the amended petition filed by the above-named petitioner, admits and denies as follows:

1, 2 and 3. Admits the allegations contained in paragraphs 1, 2 and 3 of the amended petition.

4. (A) and (B). Denies that the determination of the Commissioner is based upon the errors alleged in subparagraphs (A) and (B) of paragraphs 4 of the amended petition, or upon any errors.

A

1. Admits the allegations contained in paragraph 1 of subdivision A of the amended petition.

2 and 3. Denies the allegations contained in paragraph 2 and paragraph 3 (as corrected by motion filed January 21, 1954, granted January 22, 1954) of subdivision A of the amended petition, except it is admitted that the computation appearing on the top of page 3 of the amended petition is the same computation which appeared on petitioner's income tax return for the year 1946.

4. Admits that in the notice of deficiency respondent increased petitioner's gross receipts from his gaming business in the amount of $48,910.41 on the basis of information on file in the Bureau; denies the remaining allegation contained in paragraph 4 of subdivision A of the amended petition.

5. Denies the allegations, if any, contained in paragraph 5 of subdivision A of the amended petition.

6. Denies the allegations contained in paragraph 6 of subdivision A of the amended petition.

[fol. 8] B

1 and 2. Denies the allegations contained in paragraphs 1 and 2 of subdivision B of the amended petition.

3 and 4. Admits that petitioner, in his income tax return for the year 1946, deducted the amount of $14,563.84 as alleged wages and that said amount was disallowed by respondent in his notice of deficiency for the reason that such payments were contrary to public policy in the State of Illinois; denies the remaining allegations, if any, contained in paragraphs 3 and 4 of subdivision B of the amended petition.

5. Denies the allegations contained in paragraph 5 of subdivision B of the amended petition.

Denies generally and specifically each and every allegation contained in the amended petition not hereinbefore admitted, qualified, or denied.

Wherefore, respondent prays that the determination of the Commissioner, as set forth in the notice of deficiency, be sustained.

(Signed) Daniel A. Taylor, J.D.K., Chief Counsel, Internal Revenue Service.

Of Counsel: John D. Kiley, Regional Counsel; Gerald W. Brooks, Appellate Counsel; David H. Nelson, Special Attorney, Internal Revenue Service.

[fol. 9] THE TAX COURT OF THE UNITED STATES

STIPULATION OF FACTS—Filed March 29, 1955

It is hereby stipulated and agreed, by and between the parties in the above-entitled proceeding by their respective counsel, that the facts hereinafter stated may be taken as true and correct and accepted as evidence in this proceeding, subject to the right of either party to object to the relevancy and materiality thereof, and also subject to the right of either party to introduce other and further proof not inconsistent herewith. Exhibits referred to herein are attached hereto and made a part hereof.

1. The petitioner is an individual with residence at 1163 West Grand Avenue, Chicago, Illinois. His Federal income tax return for the calendar year 1946 was timely filed with the then Collector of Internal Revenue for the First District of Illinois. Exhibit 1-A is a photostat of petitioner's return for the calendar year 1946.

2. On September 15, 1947, petitioner filed an amended return for the calendar year 1946 which showed additional income of $310.92. Since the petitioner has consented to an assessment which has taken into cognizance the $310.92, the amended return has no bearing on the deficiency before this Court.

3. During the calendar year 1946 petitioner was engaged in the business of accepting wagers on horse races, commonly known as bookmaking, at 811 Ashland Avenue, Chicago, Illinois. Limited operations were also carried on from a handbook located at Chicago Avenue and Wood

Street, Chicago, Illinois for the first four months of the calendar year 1946.

4. The petitioner accepted bets from various individuals and agreed to pay the bettor if he won his bet such odds as were shown by the pari-mutuel machines of the various race tracks located in different parts of the country, with the limitation, that in no event would he pay more than $30.00 for $1.00, in respect of "win," $12.00 for $1.00 in respect of "place," and $6.00 for $1.00 in respect of "show." Additional limitations were 100 to 1 on daily double bets, and 15 to 1 on horses wagered on the parlay [fol. 10] bets with an over-all limitation of 100 to 1. To win a "win" bet the horse wagered on must come in first; to win a "place" bet the horse wagered on must come in first or second; and to win a "show" bet the horse wagered on must come in first, second or third. To win a daily double bet, the bettor must select in advance the winning horses in two races at a particular track, usually the first and second races. Parlay bets are similar to daily double wagers, except they may be made to win, place or show, and may be made on two or more horses at the same or different tracks. Like daily double bets the horses must be selected in advance, and all must win, place or show, depending on how they were bet to finish.

4. The petitioner had the additional limitation that he would accept no bets in excess of $100.00. The great majority of the bets taken were small, being for 50¢ $1.00 or $2.00.

5. The petitioner's income tax returns were filed on the cash receipts and disbursements basis. They were prepared by petitioner's accountant, Mr. Philip C. Corrado on the basis of the following:

(a) Bets were recorded by employees of the petitioner known as sheet writers on both betting tickets and so-called "twenty-line sheets." Each line on the sheet was numbered in sequence from 1 to 999 and the sheet itself had an alphabetical letter and color. The betting tickets were lettered, numbered, and colored to correspond with the twenty-line sheets. The sheet writer inserted a carbon paper between the betting ticket and the twenty-line sheet, and writing on the betting ticket, recorded the following information:

(1) On the extreme left the number of the horse on which the bet was placed (this number came from the hard card—see subparagraph (c) below).

(2) The bet; for example $2.00 or $5.00, and whether to win (1st blank), to place (2nd blank), to show (3rd blank), or any combination of the three. The figure or figures written in the blank or blanks, following the number of the horse on the extreme left ((a)(1)) above, represented the amount or amounts bet.

(b) The bettor took the betting ticket as his receipt and paid the amount of the wager to the sheet writer.

(c) After recording twenty bets on a given twenty-line sheet, the sheet writer turned over the sheet and the cash [fol. 11] which he had taken in exchange for the bets which he had recorded on that sheet to an employee of the petitioner known as a cashier.

(d) A large cardboard sheet, commonly called a hard card, for each track was hung on the wall in the petitioner's place of business each day. The hard card showed the entries for the day, the jockey, and probable odds. Each horse was shown by name and number and such numbers were used and written in on the safety tickets when bets were made on the various horses. (See subparagraph (a)(1) above.)

(e) The petitioner subscribed to a wire service which gave information over a loud speaker such as the time when the race commenced, the progress of the race until it ended, the result, and the odds payable at the track to the winners of win, place and show bets on the basis of $2.00 bets. A winner was required to present the original ticket to a cashier to collect his wager. When a winner presented the original ticket, it was verified against the carbon notation thereof on the twenty-line sheet retained by the cashier and if the carbon copy showed it to be a correct ticket, the notation of the amount payable for that bet according to the result at the track was entered in the last column for that bet on the twenty-line sheet and the bettor was paid according to the amount of the wager and the odds paid at the track for that race, subject to the limitations mentioned in 4 above.

Exhibit 2-B consists of twenty-line sheets showing bets written for the sixteenth of March 1946. Similar twenty-

line sheets for each day's operations were retained by the petitioner.

(f) At the close of each day, or early on the following day, the petitioner's cashier totaled the bets written according to the twenty-line sheets (i.e., the "ins") which should agree with the cash turned in to him by the sheet writer, and totaled the "outs," or amounts shown on the twenty-line sheets as bets lost by petitioner. The petitioner did not maintain a daily record of cash on hand and did not handle all receipts and disbursements through a commercial checking account at any bank. These totals together with the day's expenses for wages, stationery, rent, etc., were entered on a daily summary report. These daily reports were prepared in duplicate and one copy was sent to petitioner's accountant, Philip C. Corrado, and the other [fol. 12] retained for the petitioner. Exhibit 3-C is such a summary prepared for March 16, 1946. Exhibit 3-C is representative of the daily summary reports retained and prescribed by the petitioner for the entire period in controversy.

(g) The accountant, from the aforesaid daily reports, made a monthly summary and from such monthly summaries for the year the accountant prepared petitioner's income tax return.

6. The total "ins," the total "outs," the gross profit and the percentage of gross profit to "ins" for the year 1946 according to the total of such monthly summaries for said year are as follows:

Total Ins	Total Outs	Gross Profit	Percentage of Profit
$793,287.30	$750,069.85	$43,217.65	5.45

In the statutory notice the respondent made no change in the total reported "ins." The respondent however increased petitioner's reported gross profit by disallowing a portion of the claimed "outs." Petitioner objects to the relevancy of the percentage shown insofar as it fails to reflect scratches and returned bets.

7. In stipulating herein with respect to the nature or kind of records maintained by the petitioner and what these records show, the respondent does not admit the accuracy

or correctness of such records, nor that they are complete records of the petitioner's business for the year involved.

8. In the statutory notice of deficiency the net income as disclosed by the return in the year 1946 was increased by $58,010.41 with the following explanation:

"(b) The excess of gaming receipts over gaming disbursements, or gross receipts reported by you in your income tax return for the taxable year 1946 in the amount of $43,217.64 has been increased by $48,010.41 on the basis of information on file in the Bureau and in accordance with the provisions of sections 22(a) and 41, Internal Revenue Code."

9. At pari-mutuel racing tracks throughout the United States 10% to 17% of all bets placed is deducted for the racing association and the taxing authorities, and the remaining 90% to 83% is distributed to winning bettors. Petitioner objects to the relevancy and materiality of this statement.

[fol. 431] 10. Under 1946 Illinois statutes, Chapter 8, Sec. 37(j), racing associations kept 10% (11% where the race track was located within a county of less than 250,000 population and more than one hundred miles from the corporate limits of any city in Illinois having a population of 1,000,000 or more) of all bets placed, less 2% for taxes, plus 50% of the "breakage." For purposes of this trial it is stipulated that the breakage was 1½% of the totals wagered. The remaining 88½% (or 87½%) was distributed to the winning bettors. Petitioner objects to the relevancy and materiality of this statement.

11. No dispute exists with respect to the amount of the wage expenses incurred by petitioner in the operation of his business of bookmaking during the year involved herein, but a dispute does exist as to the propriety of the allowance of said expense as an ordinary and necessary expense under section 23(a)(1) of the Internal Revenue Code of 1939.

12. The petitioner in the conduct of his business of bookmaking paid wages to his employees in 1946 in the amount of $14,563.84. These employees performed all the services necessary in the operation of a bookmaking establishment including the recording of bets.

13. The Court may take judicial notice of section 374.1 of the Illinois Horse Racing Act and sections 336, 582 and 583 of the Criminal Code of the State of Illinois. Section 336 reads as follows:

"336. Book-making and pool-selling unlawful.

§ 1. Be it enacted by the People of the State of Illinois, represented in the General Assembly: That any person who keeps any room, shed, tenement, tent, booth, or building, or any part thereof, or who occupies any place upon any public or private grounds within this state, with any book, instrument or device for the purpose of recording or registering bets or wagers, or of selling pools, or any person who records or registers bets or wagers, or sell pools upon the result of any trial or contest of skill, speed or power of endurance of man or beast, or upon the result of any political nomination, appointment or election, or being the owner, lessee or occupant of any room, shed, tenement, tent, booth, or building, or part thereof, knowingly permits the same to be used or occupied for any of these purposes, or therein keeps, exhibits or employs any device or apparatus for the purpose of recording or registering such bets or wagers, or selling of such pools, or becomes the custodian [fol. 14] or depositary for hire or privilege, of any money, property, or things of value staked, wagered or pledged upon any such result, shall be punishable by imprisonment in the county jail for a period not longer than one year or by fine not exceeding $2,000 or both. Provided, however, that the provisions of this act shall not apply to the actual enclosure of fair or race track associations that are incorporated under the laws of this state, during the actual time of the meetings of said associations, or within twenty-four hours before any such meetings."

(Signed) Howard R. Slater, Counsel for Petitioner.
(Signed) (R. P. Hertzog, G.W.B., Acting Chief Counsel, Internal Revenue Service, Counsel for Respondent.

In the Tax Court of the United States

(Caption—50868)

Transcript of Proceedings

1212 Lake Shore Drive,
Chicago, Illinois,
Tuesday, March 29, 1955.

The above-entitled matter came on for hearing, pursuant to notice to the parties, at 10:00 o'clock a.m.

Before: Honorable Stephen E. Rice, J., Presiding.

Appearances:

Howard R. Slater, Esq., Chicago, Illinois, for the Petitioner.

Edward L. Newberger, Esq., (Hon. R. P. Herzog, Acting Chief Counsel, Bureau of Internal Revenue), for the Respondent.

The Court: You may proceed.

The Clerk: Docket Number 50868, Sam Mesi.

Statement by Mr. Slater.

Mr. Slater: If it please the court the factual issues before it this morning revolves about the gross receipts of one Sam Mesi in the admitted occupation of a handbook in the city of Chicago in the year 1946.

[fol. 15] The respondent increased the petitioner's gross receipts from his gaming ventures in the amount of some $48,000 and alleged them as notice of deficiency, that the method used in determining that the taxpayer had used in arriving at additional gross receipts was on the basis of information on file in the bureau.

To this day I still don't know what the information on file in the bureau reflects, or why. The receipts of the petitioner in this case were increased; and petitioner sets forth he has accounted for all the moneys he has taken in gross and that is likewise properly accounted for for gross reductions.

Nevertheless, we are here to show that the books kept by this petitioner were accurate, reflected all of his gross

income and that with the exception possibly of minor errors, they basically report the income for the years involved.

The stipulation which both petitioner and respondent have entered into indicates possibly that the government's case is based upon the fact that the percentage of earnings from these gross receipts was substantially less than a race track would earn on a parimutuel machine, and we have indicated in that stipulation that the percentage of earnings by a race track is irrelevant and immaterial in the case here.

Without any further ado I would like to have Mr. Corrado called.

The Court: Let us have an opening statement from the government first.

STATEMENT BY MR. NEWBERGER:

Mr. Newberger: Your honor, in addition to the issue that Mr. Slater mentioned, there is a second issue in the case which is strictly a legal issue. We have disallowed the wages paid by the petitioner on the grounds that he was engaged in an illegal activity and Section 336 of the Illinois Revised Statutes makes it a crime to pay wages to those who record bets.

We believe we cannot allow this, as to allow this expenditure would contravene public policy, and that issue in the case will be argued on that basis. We have submitted a stipulation of facts which will cover the factual issues.

As to the other point I would like to speak briefly on this for a moment. The increase of $48,010.41 in gross income is due to a disallowance by the Commissioner of petitioner's so-called pay-outs to winning bettors.

The petitioner, who is a bookie, when he receives a bet [fol. 16] records that bet as an "in"—that is, incoming bet. When a race is won and a particular horse wins, the petitioner is required to pay the winning bettor. He will list that amount as an out: that is, an outgoing payment.

Now the ins of the petitioner are his gross receipts, so you must subtract the outs of the petitioner to arrive at his gross income. We have disallowed a portion of the amounts claimed to have been paid to winning bettors. This amount was disallowed because it was unsubstantiated. The records, as presented to the Commissioner, were

not adequate for the purpose of conducting an income tax audit.

We intend to show that through evidence later at this trial. They could not be verified through any independent means. The petitioner did not maintain a bank account during the taxable years. The outs were paid in cash; there is no identification in the records of the names of the persons to whom the claimed outs were paid.

Nowhere in petitioner's records is there any indication that anything was paid for protection in spite of the fact that the petitioner ran an open bookmaking establishment. We shall introduce evidence to show that it was impossible to operate in Chicago in 1946 without protection payments. The only logical inference is the petitioner paid 35 percent or so of his profits for protection and that the outs include amounts paid for protection.

Mr. Slater: I will call Mr. Corrado.

Mr. Newberger: We have a stipulation of facts we would like to submit.

The Court: Very well; it will be received.

[fol. 17] PHILIP C. CORRADO was called as a witness by and on behalf of the petitioner, and, having been first duly sworn, was examined and testified as follows:

The Clerk: State your name, please, and your address.

The Witness: Philip C. Corrado; I conduct an accounting business at 77 West Washington Boulevard, Chicago, Illinois.

Direct Examination.

By Mr. Slater:

Q. Mr. Corrado, are you a licensed Certified Public Accountant?

A. I am.

Q. In the state of Illinois?

A. I am.

Q. And you are still qualified to this day to conduct a certified accounting practice?

A. Yes.

Q. Were you so in 1946?

A. Yes.

Q. Were you then familiar with the petitioner, Mr. Sam Mesi?

A. Yes.

Q. Did you represent him as an accountant at that time?

A. I did.

Q. Will you briefly state to the court the services you rendered to the petitioner in this year?

A. For that year we received monthly records indicating gross receipts, gross pay-outs, expenditures itemized, net income per day. Those were the records we received together with possibly some expenses which were attached to the daily record.

From those records we recap them by the month and at the end of the year summarized them and made sure that they checked out, and computed an income tax return and executed old age-benefit tax returns which were filed quarterly.

Mr. Slater: May I have the exhibits?

The Clerk: Joint exhibits 1-A, 2-B and 3-C.

(The documents above referred to were marked Joint Exhibits 1-A, 2-B and 3-C, and were received in evidence.)

[fol. 18] By Mr. Slater:

Q. Mr. Corrado: I present you with Exhibit 1-A for identification and ask you whether you recognize same.

A. Yes.

Q. Will you state what they are?

A. This is a record for the month of January, 1946, indicating gross receipts by outs, expenditures, cash reconciliation, and an indication of whether there was a win or loss for the day.

Q. Were those sheets presented to you at the end of each month during the year 1946?

A. They were.

Q. And from those sheets you prepared a monthly report?

A. I did.

Q. Did you foot and correct them arithmetically on those sheets?

A. Yes, in fact we did. The summary sheet was necessary that it be cross footed in order that our work be complete for the month.

Q. Were the reports submitted to you in 1946 arithmetically correct?

A. As filed.

Q. And for these months you prepared an income tax return for 1946?

A. Yes.

Q. The arithmetic on that report was based upon the figures in those recaps?

A. Yes.

Q. Did you use any auditing procedures in verifying the amounts shown on these daily recaps?

A. None other than in the mathematics on the sheet itself.

Q. You did do some checking, I believe, on the expenses as listed by you?

A. Yes.

Q. What did the verification procedures as used by yourself on the expenses consist of?

A. Identifying the expenditures as listed on the daily sheet.

Q. Did you trace them back to the original invoices?

A. That would be the procedure.

Q. Did you find them to be correct?

A. Yes.

[fol. 19] Q. For how many years did you perform a similar service for Mr. Mesi?

A. Either from 1938 or 39, if my recollection is correct.

Q. When you began?

A. Yes.

Q And you went how long?

A. Possibly through 1949.

Q. Did you at any time during the course of those years find other than minor errors in the report submitted by Sam Mesi?

A. No, I did not.

Mr. Slater: Your witness.

Cross-Examination.

By Mr. Newberger:

Q. Mr. Corrado, did you make any audit whatsoever with regard to so-called outs?

A. No, I did not make the audit but I was with the examining agent for the year involved.

Q. No; the question is did you make any audit?

A. I did not, no.

Q. There was no audit made by you of the outs in the preparation of the return?

A. Not by my self.

Q. Would you, as a Certified Public Accountant, give a certified balance sheet to Sam Mosi based upon your audit?

A. No, sir, I couldn't. There were no assets involved other than the cash indicated.

Q. Did petitioner maintain a cash control account in order that he would know what his daily balance of cash on hand was?

A. Pardon me; are you asking me a question?

Q. Yes.

A. Only as indicated on the daily sheets: That is, to my knowledge.

Q. I don't understand the answer. Did you he maintain any control of his cash so that you could come in as an auditor and know how much cash he was meant to have on hand.

A. No, that was not part of my arrangement or of my service with him.

Q. Because of that it would have been impossible to audit the books. Without a cash control account you couldn't audit the books?

[fol. 20] A. For particular records?

Q. In order to audit any business accounts you certainly have to know what the cash on hand is, say, at the end of a given period. If he didn't maintain that kind of an account it would be impossible to make an audit.

A. Not necessarily. In his particular records he dealt only in cash so his record at the end of each sheet that he indicated was a running control of his cash situation.

Q. There is no indication on these sheets of any items marked cash. Will you explain to the court what you mean by that?

A. Yes; the net results at the end of the day. He took in so much money; he paid out so much money. He had so many expenses. The balance was either what he gained for the day or lost for the day.

Q. Isn't it customary for a business organization to have an account called cash, which is an important account for you as a Certified Public Accountant, at the same time?

A. The records of this type of an organization are entirely different from an ordinary business. They are dealing only with cash and they have only that item to contend with at the end of the day. Therefore, if the client knows whether he made or lost money; he has all the information he requires for the conduct of his business.

Mr. Newberger: No further questions.

Redirect Examination.

By Mr. Slater:

Q. Mr. Corrado, how many years have you been a Certified Public Accountant?

A. I received the degree of Certified Public Accountant, I believe, in 1941 or 1942. Before that I was by examination licensed to practice accounting under the state law and of which I passed the examination in 1937.

Q. You have had quite a number of years in this business.

A. I have been in the accounting business practically all my life.

Q. Let me ask you a hypothetical question: If A, a bettor, walked in to a handbook, placed his bet with an individual referred to as a sheet writer who in turn made a written record of that bet and received the cash simultaneously and thereafter after he had given number of bets on one sheet, took the sheet plus the cash that that [fol. 21] sheet reflected, and turned it over to another individual referred to as a cashier, and the cashier collected such sheets all day long and paid out to the winning bettors some of the moneys now that the cashier had, and it at the end of the day the proprietor of that establishment came in and, with you as an auditor, would you be able to verify the cash on hand at the end of the day?

A. Yes; that procedure would supply the amounts.

Q. In terms of the accounting profession, there is internal control?

A. Yes.

Q. Particularly, would this be true if we started an initial impressed fund with a given amount of cash?

A. Yes.

Q. If the cashier was given a given amount of cash each day and thereafter had sheets and cash at the end of the day, the amounts and sheets should tie up?

A. Yes.

Mr. Slater: That is all.

Recross Examination.

By Mr. Newberger:

Q. You didn't see any indication of any impressed funds or the like?

A. My duties do not require attendance in the betting room.

The Court: Answer counsel's question.

The Witness: No, I did not.

By Mr. Newberger:

Q. Would you from your examinations be able to determine whether petitioner correctly reported his ins or his outs?

A. You mean could I do that?

Q. Could you in your capacity?

A. That would be impossible.

Mr. Newberger: I have no further questions.

Redirect Examination.

By Mr. Slater:

Q. Were you asked to conduct a certified audit of this man's affairs?

A. No, I was not.

Q. All you were asked to do was to make a mathematical calculation job?

[fol. 22] A. Yes.

Q. Based upon the hypothetical situation I posed to you, had you been asked you could have an audit, could you?

A. Yes.

Q. There was sufficient data in that hypothetical question so that you could have conducted a certified audit, if need be?

A. Yes.

Q. Isn't it true you don't always conduct a certified audit for all clients?

A. Yes.

Q. In some cases you maintain some high form of mathematics rather than verification procedures

A. Of limitations,—from one extreme to the other.

Q. This includes many types of business people, does it not?

A. It does.

Mr. Slater: Thank you, Mr. Corrado.

The Court: What are those sheets on which the bets are placed? Are they part of the stipulation?

Mr. Slater: These are 365 daily recaps showing in various handwritings what was taken in and given out. We have stipulated that one day out of the year, March 16, is indicative of the entire year. We selected March 16 at random by pulling it out of a box and our stipulation states that all of these things are accepted as they are. The only question is, as Mr. Newberger put it: Have we reflected our entire gross income?

To apply the percentage of gross profit earned by a race track to the gross receipts of a bookmaker is arbitrary. We claim our books reflect our income.

Mr. Newberger: I object to the use of the term arbitrary.

Mr. Slater: It is in the petition; so you deny it.

I call Mr. Maiola.

[fol. 23] FRANK MAIOLA was called as a witness by and on behalf of the petitioner, and, having been first duly sworn, was examined and testified as follows:

The Clerk: State your name and address, please.

The Witness: Frank Maiola: 1859 West Chicago Avenue, Chicago, Illinois.

Direct Examination.

By Mr. Slater:

Q. Mr. Maiola, do you know Sam Mesi?

A. Yes.

Q. Did you work for him?

A. Yes.

Q. Did you work for him during the year 1946?

A. Yes.

Q. Were you a sheet writer for him during the year 1946?

A. Yes, sir.

Q. I show you agreed Exhibit 2-B, and ask you to tell the court what the top sheet is.

The Court: You asked him what a sheet writer is, did you?

Mr. Slater: No.

The Court: I don't know what that is.

Mr. Slater: I am about to explain that through this exhibit.

By Mr. Slater:

Q. What is this piece of paper?

A. It is a sheet with a carbon on top of the sheet.

Q. Is this what is called a 20-line sheet?

A. Yes.

Q. A bettor comes in and wants to bet $1 on a given horse. First of all; how does he know which horse to bet?

A. There is a hard card.

Mr. Newberger: The stipulation of facts goes into this, so that we are not solely dependent upon this man's testimony on it.

Mr. Slater: The only reason I am putting it in is to show how the money flowed through.

The Court: All right.

[fol. 24] By Mr. Slater:

Q. Is this a hard card?

A. Yes.

Q. If the bettor wanted to bet one of the numbers on this card he would give you the number?

A. Yes.

Q. What would you do then?

A. There is a carbon sheet over this sheet and there are tickets with a number on every one.

Q. Is this the ticket you are referring to (indicating paper)?

A. Yes.

Q. You put the ticket on top of the carbon paper?

A. Yes.

Q. What do you do?

A. The number of the horse, the amount of money that he wants to bet; he gives me the money and I rip the ticket off, and there is the same amount on this as on this sheet.

Q. You would have a correspondence between the line and the cards?

A. Yes.

Q. That 007 on the line there on the sheet; after you have made a number of bets——

A. We have to add it up, give it to the cashier, and it has to correspond.

Q. Does the cashier add up the amounts?

A. Yes.

Q. Who was he?

A. Leo Wolkowiez.

Q. Have you attempted to find Mr. Wolkowicz?

A. Yes; I can't find him.

Q. How many other people were doing this job you were doing as a sheet writer?

A. Two; sometimes on Saturdays, three.

Q. Name me another one.

A. Tony Jendryka.

Q. Now, the cashier had all the money at this time. What happens if one of these people who made a bet won?

A. The cashier would pay him.

Q. Did he mark anything on the sheet when he paid him off?

A. Yes, the total amount of money he paid out.

Q. On the same line where the original payment was entered, is that it?

[fol. 25] A. Yes.

Q. Now, was Sam Mesi around during this time?

A. Well, sometimes yes and sometimes no. A lot of times he wasn't around.

Q. Why?

A. He was a sick man and has been sick as long as I have known him.

Q. Did he spend a good deal of time at the race track?

A. Either at the race track or in bed.

Q. But he wasn't there normally during the course of the day?

A. No, maybe sometimes you wouldn't see him for a week and then not for a couple weeks.

Q. Did he enter these bets on the sheet himself?

A. Once in a while.

Q. Not as a usual practice?

A. No.

Q. Do you recognize the handwriting on this particular sheet you are looking at?

A. I think it is Tony's.

Q. At the end of the day what did the cashier do, to the best of your knowledge?

A. The players go home; we take the sheets and the money and then we check up.

Q. Did he prepare a daily summary from the amounts of bets and pay outs for the day?

A. Yes.

Q. Also the money he had to pay out for expenses?

A. Yes.

Q. Did you, as sheet writers, help in this work?

A. Yes.

Q. Did Sam Mesi come around for the cash?

A. Yes.

Q. Sometimes he would wait a few days and sometimes be away for a week at a stretch?

A. Yes.

Q. Did he ever act as cashier?

A. I don't think so.

Q. Did he ever sit down with you and add up the amounts on the sheet?

A. At night?

Q. Yes.

A. When he was there, yes.

Q. And if he hadn't been there for 2 or 3 days?

[fol. 26] A. We would keep the money until he came in. He trusted us.

Mr. Slater: That is all.

Cross-Examination.

By Mr. Newberger:

Q. I show you Exhibit 2-B and ask you to look at it and tell the court how much was bet on this sheet, 007-G, 1-1-007; how much money was bet?

A. $2. $1 to win and $1 to place. It shows your there.

Q. What would the winning ticket show?

A. $40.45 pay out.

Q. How much would the winning ticket indicate was bet? What would the winning ticket show?

A. It showed $1 to win and $1.45 place on a horse.

Q. I show you ticket 007-G and ask you if this ticket is the winning ticket corresponding to the 007-G on the 20-line sheet?

A. No, you couldn't pay that on this sheet because the number is only $1 to win. It is $1 to win and $1 to place on the sheet.

Q. How do you account for the fact it is a yellow ticket; it is G and marked 007, and it comes from the same day's activities as the day in question?

A. Yes. I don't know what you mean. On that ticket we can only pay him for $1 to win if it corresponds with that one.

Q. If you can only pay $1 to win, why did you mark this $1 to place?

A. Sometimes the carbon doesn't catch.

Q. How can the carbon not catch when the thing is written on the carbon and not on the original? Would it be possible after the race had been won for one of the sheet writers to have written that $1 place in?

A. I know Mr. Mesi doesn't know anything about that.

Q. Would it have been possible to do that?

A. I couldn't answer that.

Mr. Slater: I object: this man isn't qualified as an expert.

The Court: I don't think he has to be an expert to answer that question. Do you know the question?

The Witness: Yes; how come it is $1 and $1, and it is $1 on the yellow card?

[fol. 27] The Court: No, he is asking how something else came to be written in. Do you want him to ask the question again?

By Mr. Newberger:

Q. Could someone after the race is run, write in $1 here even though that would not appear on the winning ticket? Could someone take a sheet of carbon paper, put something over it and put a $1 here?

A. I can't answer that question. I have never done it and I don't know.

The Court: Of course, the answer to the question is perfectly obvious. I thought you were going to follow it up and ask if he ever did it or knew whether anyone working for Mr. Mesi did it.

The Witness: No, I never did.

The Court: Your answer is No, I take it?

The Witness: That is right.

Mr. Newberger: I offer in evidence as Exhibit 1?

Mr. Slater: I will object to the submission of evidence on cross examination. I realize that our rules of procedure in this court are somewhat relaxed but I never heard of getting in evidence during cross examination. If he sees fit to call this man as his witness, he can offer it at that time.

The Court: How about that?

Mr. Newberger: I will offer this later.

By Mr. Newberger:

Q. Let us turn to the second page. I show you a purported winning ticket and sheet numbered Yellow 6-031, which corresponds with 031 on the 20-line sheet. Will you tell the

court what the 20-line sheet indicates was bet at number 631 on same?

A. 304, $1 to win; $1 to place.

Q. I show you this ticket. Does this ticket appear to have been the winning ticket since everything corresponds except that this ticket does not indicate anything bet to win?

A. That is right.

Q. How do you account for the fact that the carbon shows $1 bet to win, whereas the winning ticket itself shows nothing under a block marked to win?

A. That isn't my writing; I don't know.

The Court: What was your answer? I didn't hear it. [fol. 28] The Witness: I know I have been with the man for a long time; I never saw anything like that before.

The Court: Well, your answer is you can't explain it.

The Witness: No, I can't.

By Mr. Newberger:

Q. I will skip a few pages and now come to a sheet labeled on the top: M-Yellow-33. Will you take a look first at the hard card for that day and the bets placed under item 652 and compute how much the winner was entitled to? Do you want some scratch paper?

A. I can't figure parlays.

Q. You can't figure parlays?

A. No; I am not a cashier. I just write bets.

Q. I turn to another sheet: M-Yellow-34. Will you take a look at the first 9 or so horses there and tell the court which race that came from?

A. Do you want me to pick out which

Q. You see horses 1, 3, 8, 11. Will you tell the court do they come from the first race, the third race or what?

A. No, 1 is the first race.

Q. The first race where?

A. Sometimes the hard card puts different tracks.

Q. The first race?

A. No. 1.

Q. How do you account for the fact that in the middle of the page where they purported to be?

A. Big winner.

Q. They suddenly jump to the 8th race.

A. I will tell you about that.

Q. Tell the court.

A. You come in early in the morning and want to make a wager and don't want to stay; you can bet 6 or 7 races and the first race.

Q. You can what?

A. You can bet the last race and come in at post time at 1 o'clock, and perhaps he wants to make a wager in the last race,—so much on a certain number at Tropical in the last race.

Q. Is it unusual to have some in the middle and just one on the first race, but some bets in the 6th or 7th races; before the first race was over?

Mr. Slater: I object. This man isn't familiar with those records at all.

The Court: I can give him the answer.

[fol. 29] The Witness: I did give him the answer.

The Court: I asked you another question.

Mr. Slater: See if you can find another sheet where they bet the 7th or 8th race before the 1st race was over.

The Witness: Maybe I can find sheets. There is 37 going up to 213. Those are later races. They bet the 2d race. I believe that is the 2d or 3rd race.

By Mr. Newberger:

Q. What kind of bet is this, with the 213?

A. That is a parlay; that is a later race.

Mr. Newberger: I have no further questions of this witness.

Redirect Examination.

By Mr. Slater:

Q. Suppose I am a milkman and I walk into the place.

A. Yes.

Q. And I want to bet half a dollar on each of 8 races, and I put down $4 and I pick out 8 horses in 8 different races.

A. Yes.

Q. Do you write them one after another?

A. On the same sheet.

Q. The sheets I showed you and the government's attorney asked you about; are they in your handwriting?

A. Not the one he showed me.

Q. Do you recognize the handwriting?

A. There were three or four sheet writers there. I don't know it.

Q. Who made the pay outs?

A. The cashier.

Q. In whose handwriting is the pay out?

A. The cashier's.

Mr. Slater: No more questions.

Recross Examination.

By Mr. Newberger:

Q. I have one or two questions. Mr. Maiola, you wrote these bets out on so-called 20-line sheets and they were all numbered?

A. Yes.

Q. Will you explain to the court how you got hold of the 20-line sheets, who gave them to you, and what system was used in giving them to you?

[fol. 30] A. Who gave me the sheets?

Q. Yes.

A. We get them from the printing company.

Q. Did you go to a cupboard and take them out? Explain that.

A. They come in bundles, in lots.

Q. For example, if you were writing them you stick to a steady rotation. In other words, if you were writing sheet G-001 yellow, then you go on from G-001 all the way up so that you have G-002 next; G-003 next until you had used up the series 001 to 999; would that be the custom? You start out with a bundle, G-001, the next would be G-002, and I notice these are numbered on from 001 to 999. Would you use one number continuously until you start with another color; that is, would you use one color and then another, I meant to say; is that the system?

A. You have two or three sheet writers. Everybody doesn't write on the same sheet.

Q. For a given day's operations the sheets should be numbered consecutively, shouldn't they?

A. You have sheets left for the next day too. We don't throw them away. We use them. They might have different initials. Do you get my point?

Q. No.

A. No? All right.

Q. On one day's operations wouldn't be logical to use a consecutive series of numbers 001 on up to 999 even if you yourself maybe had one third of those sheets, wouldn't it be logical for the other writers to have a sequence?

A. Sometimes you have a mistake in the books too.

Q. Not frequently?

A. Well—

The Court: What counsel is asking is: What was the customary practice? Did each sheet writer go consecutively?

The Witness: Sometimes they do. Sometimes when we are busy we each take a— They run by alphabets and we each take a set and sometimes when there are some left we start out the next day with it.

By Mr. Newberger:

Q. This particular day shows at least 5 or 6 different sets being used. How do you account for that many sets being used in one day?

[fol. 31] A. Sometimes you have four or five sheets from one book and 2 or 3 sheets from another book, and we use them up, but you have to put the same numbers here that you do on there (indicating cardboard card), no matter what kind you use.

Q. Was there any control so that someone could tell the disposition of all these 20-line books?

A. You mean whether Mr. Mesi knew about it or what?

Q. If there was no control it would be possible for Mr. Mesi to throw away one of the books; say he had—

Mr. Slater: I will object to the inference.

A. I never—

By Mr. Newberger:

Q. Was there any control kept?

A. I don't know what you mean was there any control kept.

Q. Who handed you the 20-line sheets?

A. We had them there; the cashier used to give them to us.

Q. Did the cashier keep a record of what he gave you?

A. No, he didn't keep any record.

Q. There was no record kept of what you were given?

A. No.

Redirect examination.

By Mr. Slater:

Q. Where did you buy the 20-line sheets?

A. Lawton's.

Q. How many at a time?

A. Two or three sets at a time.

Q. What do you mean by sets?

A. The whole alphabet.

Q. You bought 2 or 3 sets at one time?

A. To the joint.

Q. Who was there to accept delivery?

A. Whoever was.

Q. Was Sam there?

A. He wasn't even there.

Q. Who paid for them when they brought them in?

A. I would pay him and Sammy would give me the money or I would tell him, or something else.

Q. You start out with 3 sets all numbered from A through Z?

A. Yes.

[fol. 32] Q. Suppose we have a brand new set and nothing left over from the other day, and suppose you have three sheet writers working. You came in for work, Tony came in, and a third man came in.

A. We each took a book.

Q. Any book you wanted to?

A. Yes.

Q. Did you use us all the books before you bought new one?

A. We didn't wait until we were completely out.

Q. When you saw you were running low you bought a new batch?

A. Yes.

Q. Did anybody count the books at the end of the day to see that all books were accounted for?

A. Which books?

Q. Suppose you took it into your head to make some money off Sam and you took a whole set of books and you kept your own pay off without paying to the cashier?

A. You couldn't.

Q. Why not?

A. We are all seated together there when you turn in the book.

Q. Who did you turn the books in to at the end of the day?

A. The cashier.

Q. Who did you turn in the sheets to when you made your report to Sam Mesi?

A. The cashier.

Mr. Slater: That is all.

(Witness excused.)

The Clerk: Call your next witness.

Mr. Slater: Mr. Jendryka.

[fol. 33] ANTHONY JENDRYKA was called as a witness by and on behalf of the petitioner, and, having been first duly sworn, was examined and testified as follows:

The Clerk: State your name and address, please.

The Witness: Anthony Jendryka: 1839 Iowa, Chicago, Illinois.

Direct examination:

By Mr. Slater:

Q. Mr. Jendryka, do you know Sam Mesi, the petitioner?

A. I work for the man.

Q. Did you work for the man during 1946?

A. Yes.

Q. Were you a sheet writer during that year?

A. Yes.

Q. You worked the entire year?

A. Yes.

Q. Were you paid a salary for this?

A. Yes.

Q. Did you hear the questions asked of Mr. Maiola and the answers he made?

A. Yes.

Q. Do you disagree?

A. No, that is the truth.

Q. A bettor would come in, and you would record the bet on the line and turn the sheets over to the cashier at the end of the day?

A. Yes.

Q. At the end of the day you all sat down and compared with the cashier the entire day's play?

A. Yes.

Q. Or it would be discussed with Sam Mesi?

A. Yes.

Q. All of these sheets were used with 2 or 3 there?

A. Yes.

Q. Was there always somebody watching everybody else?

A. Yes.

Q. Was Sam doing any of this writing?

A. Once in a great while you would see him.

Q. Did any of the people at the place make their bets through this book?

[fol. 34] A. No.

Q. Did you make bets through the book?

A. No.

Q. Did anybody else over there?

A. No.

Q. Did Sam Mesi book his bets?

A. No.

Q. If he did do any betting, to the best of your knowledge, where did he do it?

A. At the track.

Q. Earlier in the day you heard the government state we had to pay out at least 35 percent of our money in order to get protection. Were there ever any police in your place?

A. No.

Q. Except when you were raided?

A. That is the only time we would see them.
Q. How many times were you raided?
A. Possibly 5, 6, 7 or 8 times.
Q. What happened then?
A. They arrested us or we would call Sam Mesi or call a bondsman and go trial the next day.
Q. Who paid for the bondsman and the lawyers?
A. Sam Mesi did.
Q. Do you know how he paid for it?
A. Out of his own pocket, I guess.
Q. Did it ever show up as an expense on the books here?
A. No, sir.
Q. So far as you know?
A. No.

Cross-examination.

By Mr. Newberger:

Q. The last witness stated he thought these first few sheets were in your handwriting, is that correct?
A. No, sir; that is not in my handwriting.
Q. I show you the first sheet of Exhibit 2-B, and you see horse 304 listed at 007 on sheet G, in yellow -1, will you tell the court what was indicated by that?
A. It is 304, $1 to win and $1 to place.
Q. I show you the winning ticket correspondingly numbered and ask you to explain to the court why the winning ticket doesn't show $1 to place.
A. The only thing may be that the cashier made a mis- [fol. 35] take. There are a lot of times the bettor will come up and say: $1 to win on a horse, or may change his mind and write: $1 win, $1 place. Maybe he didn't put it on here but did on the bet.
Q. I didn't think the cashier made a bet.
A. No, but the bettor may have changed his mind and instead of $1 to win, bet $1 and $1 and the cashier didn't put it on the ticket but put it on the sheet.
Q. What happened to 031 on this sheet?
A. $1 win, $1 place.
Q. I show you a winning ticket corresponding to that

line and ask you to account for the fact that there was nothing indicated on the win block.

A. That I could not explain.

Q. Let me return to the first page and I again call attention to 007; does it appear to you that the 1 written in under this place (indicating on document) is considerably darker than all the other carbon figures on the page?

A. The only possibility is like I said; he must have written it in. The player must have changed his mind and wanted $1 and $1, instead of $1 to win on it.

Q. Or it could have been written in after the race?

A. I have never seen it done.

Q. It could have been?

A. It could have been but I have never seen it done.

The Court: Let me see if I am following your theory, Mr. Newberger. These assumptions that you are making, am I correct in understanding that if this had happened, that these marks were placed on here after the bet had been made it would tend to indicate that there were more pay outs than there actually were; is that what you are trying to prove?

Mr. Newberger: It would tend to indicate he padded his pay outs to show less profits.

The Court: That he made less pay outs than he actually did?

Mr. Newberger: Opposite to that. He showed pay outs but in fact they were fictitious entries, and that he did not, in fact, pay them out.

The Court: All right, continue.

By Mr. Newberger:

Q. I show you Exhibit 2-B, sheet M-Yellow-33, line 652, on which there were bets placed apparently on horses 213 and 223. Will you look at the hard card for that day [fol. 36] and tell the court how much a winner should collect on said bets?

A. That I don't know. This one right here are you talking about?

Q. This one (indicating on document).

A. That is a parlay. I am not much acquainted with parlays.

Q. You don't know how to figure that out?

A. No.

Q. Do you know whose handwriting this winning ticket No. 652 is in?

A. I know it isn't mine.

SAM MEST was called as a witness by and on behalf of the petitioner and, having been first duly sworn, was examined and testified as follows:

The Clerk: State your name and address, please.

The Witness: Sam Mest; 1163 Grand Avenue, Chicago, Illinois.

Q. Isn't it true that because you didn't pay such protection you were hounded and forced to move from your place of business to the garage and back to your place of business?

A. Yes.

Q. Because you wouldn't make payments?

A. Yes; I didn't see any reason to.

Q. Why didn't you make payments?

A. I didn't see any reason to.

Q. Could you afford it?

A. I didn't see any reason to.

Q. Did anybody approach you for that protection?

A. None that I saw approaching me.

Q. Were you arrested at any time during 1946 for this booking operation?

A. No, sir.

Q. Are any of those summary reports in your handwriting?

The Court: Are those the 365 summary sheets?

Mr. Slater: That is right.

[fol. 371] The Court: Don't you know where you made them?

The Witness: I made them occasionally but he asked me for these here.

By Mr. Slater:

Q. Well, let us pass that. Isn't it fairly sure you didn't make more than a handful during the course of a year?

A. Maybe 10 or 12.

Q. I show you Exhibit 2-B. Is that in your handwriting? Here is the summary report for the day of the sheets you are looking at? Is the summary report of that day in your handwriting?

A. No.

Q. Whose handwriting is it in?

A. It should be in the cashier's, I believe.

Q. Mr. Mesi, for how many years have you been a horse bettor?

A. I have been betting horses ever since I can remember.

Q. Are you fairly familiar with the techniques of placing a bet on a horse?

A. Yes.

Q. Explain why it is possible for a race track to make 14 percent net on their bets and you conceivably would earn zero, or lose money.

A. If you read the records and the Form, it shows what percentage the race track takes.

Q. They have a guaranteed take under the law?

A. Yes; some tracks take 12 to 14; sometimes as high as 18 percent.

Q. The law permits them to do this?

A. That is their law.

Q. You pay off on race track odds?

A. Yes.

Q. Do you have a completely balanced book like the race track does?

A. No.

Q. Isn't it true that some of your people may have been only on the winners so that you could end up losing money for the day?

A. That is possible. You have to have more winners than losers, in order to lose.

Q. Isn't it true during 1946 you had many days in which you ended up with a net loss in the betting for the day?

[fol. 38] A. On the summary?

Q. Yes.

A. Yes.

Q. And that such losses are correctly reported on these sheets?

A. Right.

Q. What was the average type of bet you received at your place?

A. Here (indicating on document): $1, $2, half a dollar, $3 to win, $3 to win, $5 and $5.

Q. Those horizontal lines,—show them to the court.

A. 50 cents win, $1 to show.

Q. Show that to the court. The horizontal line reflects 50 cent bets?

A. 50 cent bets; and here is $1.

Q. Did you ever receive any large bets, $1,000, for example?

A. No.

Q. What was your average bet?

A. $1, $2, 50 cents, $3, $5.

Q. The type of people who were betting with you, what type of people were they?

A. Working class, a few business people.

Q. They would stop in on their way to work and place some bets?

A. That is right.

Q. When did they collect?

A. That night; maybe the next day.

Q. If they showed up the next day, how did you show it on your summary sheets?

A. If they did not collect a bet,—you see, like this? That means that the party didn't collect that bet. They would put that in an envelope and the next day the party would come in with that ticket numbered that way, and they would get that envelope.

Q. Other than Wolkowiez have you had any other cashier?

A. Since 1946, no.

Q. Have you been able to find him?

A. No.

Q. Do you have any reason to think he would cheat you out of any money?

A. I trust them all.

Q. So far as you know he didn't cheat you of anything?

[fol. 29] A. No.

Q. There was an inference that conceivably pencil writ-

ings could be put on these sheets after the race was done so that you could pad your pay outs. I ask you as to 007-G-Yellow, did you pad that entry yourself?

A. No.

Q. Is it possible for a 20-line sheet to be already in the cashier's hands and the bettor change his mind and want to increase the bet?

A. Yes.

Q. Would the cashier necessarily do it on the ticket of the bettor?

A. I trusted the cashier and if you went up there with a ticket and you had changed your mind about the bet you made and you wanted to change it; he was authorized to do it.

Q. Without bothering with anybody?

A. Without bothering with anybody.

Q. How often did this happen?

A. Maybe you won't have one for a week and maybe on the same day you would have 9 or 10 occasions of that kind.

Q. Mr. Mesi, I take it you were acquainted during the year 1946 with at least some of your customers, were you not?

A. On sight.

Q. Do you know any of them?

A. By name?

Q. Yes.

A. I remember one fellow; he was a doctor.

Q. What was his name?

A. I can't even think of his name. He went into the army.

Q. Out of all the customers you had that year, and you must have had hundreds, you can't recall one name?

A. This is 1955. 1946 is 9 years ago. If you do not see people for 9 years I don't think you will remember them either. I know I don't.

Q. During the year you operated did you then know the name of any of your customers?

A. Very few because I wasn't there that long to get acquainted with them. Most of the time I went there in the evening.

[fol. 40] Q. Did you ever lay off any bets?

A. No, sir.

Q. Did the policeman on the beat near your place of operations ever visit you, ever speak to you?

A. If I went past him I would wave to him; he didn't speak to me.

Q. Did you ever pay him anything?

A. No.

Q. At Christmas time?

A. No.

Q. Did you make any political contributions in the year 1946?

A. No.

Q. Did you maintain a bank account for this operation?

A. No, sir.

Q. Did you have any inventory control of the 20-line sheets used in the operations?

A. Did I have control of them?

Q. Inventory control so that the men would get them in a set sequence?

A. No, sir.

Q. How could you tell whether some of them were missing or not?

A. I never checked to that effect.

Q. You never checked?

A. No.

Q. How did you keep the cash that was used to operate this business?

A. What do you mean, keep the cash?

Q. There was no bank account; tell the court what system you used.

A. Here is the system I used. I gave them $300 for a bank loan for operating expense and at night time if I went there, say if they won $100, I would take a recap and $100, and they would still have $300 for the next day. And if they lost I would reimburse them their losses.

Q. Mr. Mesi, are you familiar with computing wins and losses for salaries and the like?

A. Yes.

Q. I show you Exhibit 2-B, Sheet M-Yellow-33, 652.

A. That is a daily double.

Q. That is all right. You are familiar with computing daily double bets?

A. Yes.

Q. Will you look at the hand card and tell the court [fol. 41] how much this person should have won betting on horses 213 and 223?

A. $95.

Q. How do you compute that? Horse 213 in the first race won what?

A. It paid $8.60.

Q. So how much would be riding on the daily double?

A. The other horse paid $16.40.

Q. And how do you compute $95 out of that?

A. We don't compute it. That is what the race track paid, $95 for the daily double.

Q. This first horse paid $8.60 for $2, right?

A. Right.

The Court: Are you shifting from a daily double to a parlay? He has testified to a $95 figure for the daily double.

Cross-examination.

By Mr. Newberger:

Q. How do you know it is a daily double and not a parlay?

A. Do you see this "d" here?

Q. Mr. Mesi, do you see on this sheet we have here M-Yellow-33, carbon marks? Can you see, faintly, carbon marks?

A. No, sir. Here is another thing. You know these sheets,—how old they are.

Q. I show you the following page, M-Yellow-34, entry 671 in which horse 114 apparently won. Will you look at the hand card and tell us what the winnings should be?

A. 114 paid $19.60.

Q. And how much would the win be?

A. $88.

Q. How do you figure that?

A. For $20 it would be $196.

The Court: What are you back on now, the parlay?

Mr. Newberger: No, this is a different bet.

The Witness: This is a different bet.

By Mr. Newberger:

Q. I will ask you to figure that out again. How much should the winner have received on horse 114 bet at entry 671 on the 20-line sheet?

A. $98.

Q. And what is written on here?

A. $88.

[fol. 424] Q. Didn't the winner holler for that extra $10?

A. I don't know. If I had been there, I would have known.

Q. Mr. Mesi, how do you explain the irregularity in these 20-line sheets?

Mr. Slater: I object to the conclusion that there is an irregularity.

The Court: Well, rephrase the question. Ask him to explain what you want him to explain.

By Mr. Newberger:

Q. Mr. Mesi, on t heceni2s0es-ishet fTh5-bLh

Q. Mr. Mesi, on these 20-line sheets you go from G-4-Yellow to G-6-Yellow, and then, for example, you jump to 11.

A. G-4 to G-6.

Q. You say G-4, 2, 3, 4, 5 and 6, and then you jump to 11. How do you account for that?

A. It is possible that the day before they may have been working on these, and a different sheet writer was working, and they maybe had that book and finished up on it.

Q. Why did they jump then to M-Yellow-10?

A. This is 11, 10 is here (indicating).

Q. Why do you jump to M?

A. Maybe they took a different series. Do you find any more G-Yellows?

Q. No.

A. That is probably it. They probably finished the book the day before. If there are 2 or 3 sheet writers they have each a different book.

Q. As you go into the yellow series, Yellow-M's, and you go from 10 and then you jump all the way to 38, how do you account for that?

A. They may have been working on that the day before.

Q. Then you go from 32 to 39 and jump another letter to K; how do you account for that?

A. They probably grabbed those books. As you get all these sheets you will find they all follow each other, you understand; say you get that whole month's supply—they will follow each other.

Q. But there was no system in the day to day's use. Judging from these simple entries they would take them hit or miss.

A. They would take them and grab them as they came.

Q. Did you personally ever check to ever see that all the sheets were on hand for any given period of time?

[fol. 43] A. You mean did I check them and see that they had?

Q. Yes.

A. No.

Mr. Newberger: I have no further questions.

Redirect examination.

By Mr. Slater:

Q. Were your books of account examined by an Internal Revenue agent for 1946?

A. Yes.

Q. Was that man's name Prehn?

A. William Prehn.

Q. Did he discuss the results of his examination with you?

A. Yes.

Q. What did he say as to the condition of your books and records?

A. At that time I had all the bills and he said everything was in order with the exception of some items I didn't have any bills for.

Q. Did he disallow those items?

Mr. Newberger: I object, as hearsay.

Mr. Slater: It is not hearsay. He happens to be an agent for the respondent. I can produce him. This is an admission against interest and I don't think it is hearsay when he presents a report. All I have to elicit is what he admitted to my client.

The Court: You are not going to call him?

Mr. Newberger: No.

The Court: Then I will overrule your objection. Go ahead.

By Mr. Slater:

Q. What did he state about your books?

A. He said everything was in order with the exception of some items I didn't have any bills for.

Q. Did he disallow those items?

A. Yes.

Q. Did you pay a deficiency for those items?

A. Yes.

Q. They are not involved today though?

A. No.

Q. Inference after inference has been made by the government that you have distorted these records and withheld money for yourself for your own purposes and conceivably used them for yourself for your own purposes and conceivably used them for protection purposes. I ask you did you do so?

[fol. 44]

A. No.

Q. The government fixed upon three different lines——

Mr. Newberger: This is testimony, not speeches.

Mr. Slater: I am not making speeches.

By Mr. Slater:

Q. (Continued.) The government picked out three lines showing a bettor had paid for a win and place bet whereas the ticket only showed a bet to place.

Another showed where a bettor had been underpaid on his winnings. Another shows where he had been paid off on a bet to win but had made a bet for win and place. You state this could have occurred after a bettor stepped up to the cashier and added to his original bet?

A. Yes.

Q. Were you ever present when those things took place?

A. No.

Q. To the extent a bettor had been underpaid you profited by that, did you not?

A. Right.

Q. But you didn't take off the total amount as would have been paid him, or, rather, that he should have been paid, on your tax return, but you only took off what he was actually paid?

A. Yes.

Mr. Slater: I have no further questions.

Mr. Newberger: I have no further questions.

The Court: You testified on direct examination this place was rented about 6 times in 1946?

The Witness: Yes.

The Court: And some of your employees were arrested?

The Witness: Yes.

The Court: And you were never arrested during 1946?

The Witness: No.

The Court: Did the police know you owned that business?

The Witness: They were always looking for me. They wanted to arrest me.

The Court: Did they know you?

The Witness: If they saw me?

[fol. 45] The Court: Yes.

The Witness: Yes, some knew me. Not all of them.

(Witness excused.)

Mr. Slater: I have no further testimony. That, plus the stipulation, constitutes the petitioners' case.

Colloquy Between Court and Counsel

The Court: Let me ask you: you had 2 or 3 winning tickets there. What was it,—3 that you showed these various witnesses?

Mr. Newberger: At least 3 or 4.

The Court: Where you thought they had been changed somewhat.

Mr. Slater: The tickets themselves weren't changed.

The Court: There were additional entries on the carbon?

Mr. Slater: Yes, which aren't reflected on the 20-line ticket.

The Court: Let me know, do you have a bunch of those, a great many, or is that all you have?

Mr. Newberger: We have taken only one day to exemplify this case, March 16 as representative. We have not

made any attempt whatsoever to go through any of the record other than March 16, so we are only going to show the ones we have shown so far.

The Court: Does the stipulation take care of that? What I am trying to find out is: Are there a great many of these or are these the only ones?

Mr. Newberger: These are the only ones because we both have stipulated we agreed that this day is representative of all the days.

Mr. Slater: It is representative in the sense that it reflects the method of bookkeeping used by the petitioner in this case.

The Court: You are leaving me up in the air.

Mr. Slater: I don't know whether it represents a percentage of error represented by these three tickets. I didn't know there were any errors. We selected these at random. There are boxes that could go up to the ceiling.

The Court: You mean for just 1946?

Mr. Slater: That is right. These were examined by the Revenue agent named Prena. He presumably found them in order. For the purposes of our stipulation respondent and I agreed we would put our hand in the box and pull out one day.

The Witness: Tell me what that means.

[fol. 46] Mr. Slater: I am not going to stipulate that this percentage of error took place every day in the year. I don't know that to be the case. All I will stipulate is, and do stipulate to, is the methods used were used every day in the year but I don't say these three tickets are indicative of a method in which they are inconsistent in themselves.

Mr. Newberger: Do you think the data is representative for all the year or do you think we took a year which is not representative.

Mr. Slater: The theory of the petitioner's case is very simple. Our theory of the petitioner's case is very simple. Our theory is that our books are substantially correct. No, I couldn't contend they are 100 percent correct. The stipulation was worded that way. All I attempted to show is that the books were substantially accurate and substantially did reflect what took place.

To the extent respondent tries to show the records were meaningless, I will not agree that they were.

The Court: What is your idea?

Mr. Newberger: To take one day. If we were to take more than one day I would have the agents go through these records and obviously many things would be found there, in a few pages.

Mr. Slater: I don't think it is obvious. I do know it was done and a report was made on it. No change was recommended except minor errors.

Mr. Newberger: Changes were made.

Mr. Slater: And I still don't know what that information is, Mr. Newberger.

The Court: You are familiar with the revenue agent's report?

Mr. Slater: Certainly.

The Court: Aren't you aware that there were a great many more of these irregularities or there were not? It has to be one way or another.

Mr. Slater: I say he happened to find these.

The Court: I am asking Mr. Newberger.

Mr. Newberger: The agent assigned to me yesterday came up with a few errors and the only reason one day was used was because I understood and agreed with Mr. Slater to take one day as representative.

Mr. Slater: I don't know what his idea was. The stipulation was entered into to take one day as representative.

Mr. Newberger: If this day isn't considered representative, we are going to have to go through all these records. [fol. 47] Mr. Slater: It seems to me you have had several years in which to do so, that you have already availed yourself of the opportunity.

Mr. Newberger: The records were only made available during the last week.

Mr. Slater: No, in 1948, 1950, 1951; they were gone into in great detail in the office of Mr. Corrado who was here and testified. I am sorry I didn't speak to him or the revenue agent; and that the agent gave him a pass. The only thing discussed was that this man's percentage of gross on bets was lower than the race track percentage. At no times was it suggested that there were errors in his bookkeeping until this morning.

Mr. Newberger: We haven't accepted his books.

Mr. Slater: But you haven't indicated why you haven't accepted his books.

Mr. Newberger: The outs have not been substantiated.

The Court: Insofar as you have mentioned the three tickets, or whatever it is, the inference is against you that you were trying to prove by it that possibly somebody came in and changed their bets.

Mr. Slater: Would you simplify it if I agree it is representative of the entire year?

The Court: It would, on my part. It has been worrying me ever since the respondent brought it up. I think that would be very important. If it is only three, that seems to me sort of against the government's proposition.

Mr. Slater: Do you have anything more to enter into at this time? The government has had me in surprise for four years and I think I should know what they are going to do.

Mr. Newberger: The most we are going to deal with is 4 or 5 and most of them have been covered.

Mr. Slater: Then I will stipulate the entire year is represented by this one day.

The Court: What is that again, Mr. Newberger?

Mr. Newberger: In our further testimony the most errors we will show will be possibly five, in the review we have covered. There may be others; I am not certain.

The Court: Similar to the ones you have had testimony on?

Mr. Newberger: Yes.

The Court: Go ahead.

[fol. 48] NORMAN HANDELSMAN was called as a witness by and on behalf of the petitioner, and, having been first duly sworn, was examined and testified as follows:

The Clerk: State your name and address, please.

The Witness: Norman Handelsman, 2735 West Sunnyside, Chicago, Illinois.

Direct examination.

By Mr. Newberger:

Q. With whom are you employed?

A. The Internal Revenue Service.

Q. What is your work?

A. Internal Revenue agent.

Q. How long have you been an Internal Revenue agent?

A. Since 1946.

Q. State your educational background.

A. I am a graduate from the University of Illinois College of Commerce; I hold the degree of Certified Public Accountant, and I am a member of the bar of the state of Illinois.

Q. Have you any accounting experience other than that which you have had as an Internal Revenue agent?

A. Yes.

Q. You state you are a Certified Public Accountant?

A. Yes.

Q. Will you state for the court briefly what an audit is?

A. An audit is an examination of books and records of an organization to determine its financial position at a given date, and the results of its operations for a certain stated period.

Q. Would you state what the purpose of an audit for income tax purpose is?

A. If the audit is made by the Internal Revenue Service its purpose is to determine whether or not the net income reported on the taxpayer's return is actually the correct net income.

Q. Have you examined any of the records maintained by this taxpayer?

A. Yes.

Q. Have you an opinion as to the adequacy of the taxpayer's records?

[fol. 49] A. Yes.

Q. That opinion is for the purpose of conducting an income tax audit?

A. Yes.

Q. Will you state what that opinion is?

A. My opinion is you cannot make an income tax audit of these records.

Q. Will you tell the court the reason for that opinion?

A. The reliability or the accuracy of these records can not be verified through any independent means. It is impossible to determine whether or not the amounts actually paid out, the amounts indicated as pay outs have actually been disbursed by the petitioner.

There is no way of determining whether these amounts have actually been paid out.

Q. So when you say there can be no substantial you are referring to the fact that there is no way of substantiating the outs?

A. Yes; the government must accept the records as submitted because there is no independent means of verification.

Q. As a Certified Public Accountant would you be required—what books and records a taxpayer must maintain to satisfy the Internal Revenue Code?

A. Yes.

Q. What sections in the old Code indicate that, do you know?

A. I believe they are Sections 41 and 54.

Q. I guess you are required to know that as an Internal Revenue Agent?

A. Yes.

Q. Do the records of this petitioner satisfy that?

A. No, they do not satisfy 41 and 54.

Mr. Slater: I object.

The Court: Overruled.

By Mr. Newberger:

Q. In making satisfactory audit of a bookmaker, what information and records would be required?

A. I think you must have the name and address of each payee in order to determine whether the outs have actually been paid out.

Q. Do you think it is necessary to have an inventory control of the 20-line sheets?

A. Yes, I do.

[fol. 50] Q. Tell the court why.

A. If there is no inventory,—I wil put it on a negative basis; for example, in this particular case here, the sheets are not submitted in sequence so that a sheet writer or the proprietor can eliminate an entire group of sheets indicating bets placed and there would be no way of determining whether these sheets have been withdrawn and the amounts excluded from the taxable income reported.

If there is an inventory control and the sheet writer or proprietor must account for each single set it is possible

by inventorying these sets to determine whether or not each bet which has been reported has been returned as reported income on the return.

Q. You didn't mention the need for a cash control. Would you say without some form of cash control account it would be possible to audit a taxpayer like Mr. Mesi?

A. All the cash account does is it is of additional assistance in conducting an audit and in a cash business like a bookmaking business, without some control over the cash there is no way of tying in the amounts reported at the ends of the day with the payment sheets indicating the bets of the player.

Q. I show you Exhibit 2-B and turn to page M-Yellow-33, specifically number 652. Do you see on this section to the right of 652 any carbon imprint?

A. Well, I see an imprint in the column above 652 indicating where the previous safety ticket laid at the time the previous bet was placed. There is a line here indicating where the previous ticket was placed. I think we have some blank safety tickets which would indicate how that operates. These are the blank safety tickets, when the bettor places win, place and show bets. There is a carbon underneath. This carbon leaves an imprint after each ticket is marked.

Q. I show you Exhibit D.

(The document above referred to was marked Respondent's Exhibit D for identification.)

By Mr. Newberger:

Q. I show you Exhibit D; is this a typical 20-line sheet?

A. Yes.

Mr. Newberger: I offer this in evidence as Respondent's Exhibit D, as representative of 20-line sheets in general.

[fol. 51] Mr. Slater: I object. It is a typical 20-line sheet already in the record.

Mr. Newberger: This is a typical 20-line sheet not used.

Mr. Slater: We have stipulated about each and every item. Secondly, that new one is a little different than the one over here; thirdly, it is made in 1953 and not in 1946. On all of those grounds I would object.

The Court: You are just trying to offer it to prove the carbon marks?

Mr. Newberger: I am only introducing it for the witness to testify about the carbon marks. I don't think it is necessary. It is purely offered for clarification purposes. It has not intrinsic value in itself.

The Court: Go ahead. I will accept it. It is received in evidence.

(Thereupon the document heretofore marked respondent's Exhibit D was received in evidence.)

By Mr. Newberger:

Q. Mr. Handelsman, I show you Exhibit D. With the aid of this exhibit do you think you could explain to the court a little bit more about these carbon marks you were trying to explain before?

A. These safety tickets here leave an imprint underneath the carbon. This is the equivalent of your pegline sheet here, leaving an imprint showing where the safety ticket left off. This one was right on this line and this one right above it so that this safety ticket down here commences, the top of the safety ticket, approximately even with this line, and that this safety ticket ends approximately even with this line. They don't always run in lines like this.

Q. But you can tell from the carbon where a saf ticket ends?

A. That is right.

Q. On the basis of that, will you show the court what you would state with regard to this particular winning ticket, 652-M?

A. These records were presented to me yesterday afternoon, and going through there on this rather large bet I noted there was a different handwriting here, that the one previous to this, 651, seems to be similar to the one on 652.

Mr. Slater: I would like to interrupt his testimony. [fol. 52] The gentleman has been qualified as a Certified Public Accountant. I made no objection. I don't see where he is a handwriting expert or an expert on safety tickets.

The Court: Your objection is well taken. That is, as to the testimony on different handwriting.

A. (Continued.) There is a carbon line equivalent to the line drawn on here which commences right here which would mean this safety ticket at the time it was listed on the 20-line sheet, laid on the 20-line sheet in this manner, to put the top carbon here; can you see it?

The Court: Yes, I can see it.

A. (Continued.) When you raise this up you will see that this upper is quite a bit higher than the two under the imprint, which leaves the indication that this safety ticket was not written at the same time and in the same sequence as it should be written,—651, 652 and 653.

Mr. Slater: I will object to that.

The Court: Wait just a minute. Why do you say it wasn't written at the same time?

The Witness: Because, as I say, since if this was even here, this top of the line would indicate——

By Mr. Newberger:

Q. Before being torn off, before being detached?

A. In other words, this 651 and 653 were written in sequence and 652 was not and that 652 was written at a period subsequent to 653 rather than in a sequence of 651, 652 and 653, because if it was written at the same time the imprint left with this carbon line would be exactly even, laying on the 2, and as such we have approximately one-sixteenth of an inch or so difference in the carbon imprint.

The Court: Unless the ticket had been canted a little bit when it had been written. I don't know that you can draw a definite opinion from that. That is your opinion, of course. Go ahead.

Mr. Newberger: That is all of my questions.

Cross-Examination.

By Mr. Slater:

Q. If the book was slightly irregular and the tickets were placed together, and please keep in mind that the safety book used in the 1946 case is somewhat different than the one you are talking about,—if it was irregular and placed a little improperly, would you still get a different imprint?

[fol. 53] A. This ticket would have to be even with this line.

Q. Suppose they were all pushed up?

A. Then this line would not be where it has.

Q. It has nothing to do with the tickets?

A. These lines always run in sequence, that if the ticket is written as it is now, this 2 would have to be in absolutely the same position as the 2 on the carbon sheet of the 20-line sheet. If this 2 was laid even it would indicate it was not written at the same time.

Q. What is the total payment of that page?

A. $108.30.

Q. $108.30?

A. Yes.

Mr. Slater: I will renew my objection to his testimony and the conclusion on this evidence.

The Court: All right; I will overrule you on that.

By Mr. Slater:

Q. There is a petty cash impressed fund?

A. A petty cash impressed fund is a fund maintained that has the same amount of cash at all times. You add to the fund if the fund needs additional cash; or, if it has a larger amount, you will withdraw it.

Q. I think you will agree that that wouldn't satisfy the Certified Public Accountant examination.

A. I gave you a definition of the petty cash impressed fund.

Q. Let us say the petty cash impressed fund consists of $100 and I turn it over to my petty cashier and I tell my petty cashier: You can spend this money for certain purposes. You can also take in money because you would be cashing checks, etc. but at the end of the day I want you to turn over all your receipts and what you have paid out plus whatever cash you have paid out and at the end of the day I leave with what is over $100 and if she has less than $100, I build her up to that. Is that a petty cash impressed fund?

A. Yes.

Q. Where is this different from this bookie, where he started with $300 and at the end of every day he took

away everything he had more than $300 and, if less, he built it up?

A. There is no total indicating the dates.

Q. You have the dates?

[fol. 54] A. You asked me a question and are interrupting before I have finished.

Q. Go ahead.

A. From the testimony I heard, this individual did not go to this place every day to collect the funds, so there must have been a running total at various times indicating how much was paid over by the cashier or whoever handled the funds. There is no indication of the dates and amounts.

Q. Where individuals who had no interest in this business who were working for daily wages and daily sat down with the cashier who didn't appear, summarized the day's operations, and when Mesi came around they gave him summaries for two days. Do you audit that, Mr. Handelsman, or do you not?

A. No; I say you cannot make an audit for that.

Q. Do you mean to tell me Sears Roebuck sets up a petty cash fund, they can't audit it?

A. When their payments are made, the names and addresses appear.

Q. Suppose the names didn't appear but there are, say, receipts by individuals who swore to it, would that constitute a petty cash fund?

A. Would you repeat that?

Q. Suppose you have sworn receipts for every nickel in cash signed for by people that swore to it, that is, what they have had daily, that this is what they had at the end of the day, and the rest is paid over to the petitioner?

A. All I can say is that there isn't an audit if there isn't independent verification.

Mr. Slater: This man testified he is a Certified Public Accountant. Let him give me an accounting conclusion.

A. (Continued.) I will say this that there isn't a certified public accountant in the city of Chicago who will give you a certified balance sheet or certify as to the accuracy of the bookmaker.

By Mr. Slater:

Q. Do Certified Public Accountants accept certificates for certain things?

A. Yes.

Q. What do they accept certificates for?

A. For an inventory.

Q. What else?

A. For a statement from a bank.

[fol. 55] A. What else?

A. Accounts receivable.

Q. And all we have done is gotten somebody to say under oath that this is what it is, isn't that the case?

A. I don't know whether it is under oath.

Q. It doesn't have the juridical safeguards we have here today?

A. That is true.

Q. You got two individual people get on the stand and swear it was turned over to Sam Mesi.

A. You are asking what an accountant would say.

Q. From that could you say whether you could certify an audit?

A. No.

Q. Did you check the accuracy of these reports?

A. Yes.

Q. Did they check?

A. A few errors in the calculation of winning bets.

Q. Were those substantial?

A. Well, if I had the safety tickets——

Q. Were they substantial?

A. No, not in large amounts.

Q. You would insist as a Certified Public Accountant where I have an independent opening balance and cash, I have a closing independent balance and cash, and I have sworn receipts, that I don't have a petty cash impressed fund for an audit?

A. I wouldn't say that.

Q. Do we or don't we have an impressed fund?

A. We have an impressed fund only in method of handling.

Q. Is an impressed fund subject to a certified audit?

A. Yes.

Mr. Slater: That is all; your witness.

Redirect Examination.

By Mr. Newberger:

Q. I don't think the court has completely understood the testimony with reference to this ticket M-652. I would like to ask you a few more questions. If you take a ticket, a ticket is placed over the 20-line sheet, is that not correct? That is the way the book is formed?

A. Yes.

Q. And there is a carbon in between, is that correct?

A. Yes.

[fol. 56] Q. And you can see if you look at it closely that there is a mark,—the carbon leaves a mark indicating on the 20-line ticket, the exact dimensions of the cardboard cover ticket, is that correct?

A. Yes.

THE TAX COURT OF THE UNITED STATES

SAM MESI, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 50868

Findings of Fact and Opinion—December 16, 1955

1. Petitioner operated an illegal bookmaking business in 1946. His records and income tax return for that year disclose a gross profit of 5½ per cent on the total bets received. Respondent accepted the accuracy of the reported gross receipts and operating expenses but determined that petitioner had overstated the amounts paid to winning bettors. Respondent disallowed $48,010.41 of the wagering losses claimed by petitioner. This amount was arrived at by increasing the percentage of gross profit earned by petitioner to 11½ per cent on the basis that 11½ per cent of the amounts bet at the pari-mutuel machines at certain race tracks in Illinois was retained for the benefit of the racing association and the tax authorities. *Held*, the gross profit earned by petitioner bears no relation to the percent-

age retained out of amounts bet at pari-mutuel machines, and respondent's determination is excessive. However, because of petitioner's failure to explain certain discrepancies in his records, it is *Held, further*, that he overstated deductible wagering losses by $5,000 on his return for 1946.

2. Petitioner paid wages aggregating $14,563.84 to employees in his illegal bookmaking business during 1946. The payment of the wages, in and of itself, constituted an illegal act. *Held*, such payments violated the clearly-defined public policy of the State of Illinois and are not deductible as ordinary and necessary expenses under section 23(a) (1)(A) of the 1939 Code.

Howard R. Slater, Esq., for the petitioner.
Edward L. Newberger, Esq., for the respondent.

[fol. 57] This proceeding involves a deficiency in income tax determined against Sam Mesi (hereinafter referred to as petitioner) in the amount of $41,555.81 for the taxable year 1946.

The issues to be decided are: (1) whether petitioner overstated the amounts paid to winning bettors in reporting the gross income from his bookmaking business; and (2) whether the amounts paid by petitioner as wages in the conduct of his illegal bookmaking business are deductible as ordinary and necessary business expenses under section 23 (a)(1)(A) of the 1939 Code.

Some of the facts were stipulated.

Finding of Fact

The stipulated facts are so found and are incorporated herein by this reference.

Petitioner resided in Chicago, Illinois, during the calendar year 1946 and filed his Federal income tax return for that year with the collector of internal revenue for the first district of Illinois.

During the year 1946, petitioner was engaged in the business of accepting wagers on horse races, commonly known as bookmaking. Petitioner operated his gambling business from three or four different locations at various times during that year. He had a principal location for which he paid an annual rental, but he was compelled to move about because of raids by the police. He operated

from garage and even in basements, hallways, and alleyways during certain periods in 1946.

Petitioner spent very little time at his bookmaking establishment during the daytime. He occasionally visited it in the afternoon and usually went there in the evenings when the summaries of the day's activities were being prepared. Although engaged in an illegal business and although his establishment was raided several times during 1946, he was not personally arrested at any time during that year.

Petitioner's gambling business was an extensive one. Although the great majority of the bets taken were small, being for $.50, $1.00 or $2.00, and though no bets in excess of $100.00 were accepted, incoming bets totaled $793,287.50 in 1946. He employed six or seven persons during that year, paying them gross wages in the amount of $14,563.84. [fol. 58] Among these employees were a cashier, two or three sheet writers who accepted and entered the incoming bets, men on the "hard cards," and a doorman. The "hard cards" were large cardboard sheets, one for each track, which showed the entries for the day, the jockey, and the probable odds. Each horse was shown by name and number and such numbers were used in designating the horses on the betting tickets. Petitioner subscribed to a wire service which broadcast racing news over a loud speaker, such as the time when a race commenced, the progress of the race until it ended, the result, and the odds payable at the track to the winners of "win," "place," and "show" bets.

Petitioner paid winning bettors according to the odds shown by the pari-mutuel machines at the race tracks with a limitation that in no event would he pay more than $30 for $1, in respect of a bet to "win," $12 for $1, in respect of a bet to "place," and $6 for $1, in respect of a bet to "show." Certain additional limitations were imposed on daily double bets and on parlay bets.

Bets were entered by the sheet writers on small, printed cardboard tickets, approximately 1½ by 5 inches in size. Each ticket bore an alphabetical and numerical designation in addition to its identifying color. The tickets were attached in groups of 20 to sheets of paper approximately 5 by 13½ inches in size, which are called 20-line sheets. The tickets were arranged and attached, in numerical sequence, in such fashion that each of the 20 tickets was

directly over a line bearing a number corresponding to that on the ticket. Series of these sheets and tickets were bound together in book form and purchased, as they were needed, from a local supplier. When entering a bet, the sheet writer would insert carbon paper between the betting tickets and the 20-line sheet and simultaneously record on the ticket and the 20-line sheet the amount of the bet, whether the bet was to "win," "place," "show," or any combination of the three, and the code number which indicated the track, race, and name of the horse on which the bet was placed. The amount of the bet was then paid to the sheet writer and the betting ticket was detached and given to the bettor as his receipt. After recording 20 bets on a given 20-line sheet, the sheet writer turned over the sheet and the cash taken in with respect to the bets recorded on that sheet to the cashier employed by petitioner.

The sheet writers obtained their books of betting tickets [fol. 59] and 20-line sheets from the cashier. Such books were not necessarily used in alphabetical or numerical sequence. The cashier maintained no inventory or running record of unused books, or of tickets received, on hand or disposed of.

A winner was required to present his ticket to the cashier in order to collect his wager. When presented, it was verified against the carbon copy on the 20-line sheet possessed by the cashier. If the carbon copy showed it to be a correct ticket, the amount payable for that bet, according to the result at the track but subject to the limitations enforced by petitioner, was entered on the 20-line sheet immediately adjacent to the carbon notation of the bet and the bettor was paid in cash by the cashier. No receipts were obtained from the bettors and petitioner's records do not disclose their identities.

At the close of each day or early on the following day, petitioner's cashier totaled the bets written on the 20-line sheets, referred to as the "ins," and also totaled the bets shown on such sheets as having been paid off by petitioner, which were termed the "outs." These totals, together with the day's expenses for wages, stationery, rent, and other incidentals, were entered on a prepared form known as a daily summary report. The daily summary reports were prepared in duplicate and one copy was set to peti-

tioner's accountant and the other retained for petitioner.

At various times during the year, petitioner's accountant prepared a monthly summary on the basis of the daily summary reports which had been submitted to him. He prepared petitioner's income tax return for the year 1946, on the cash receipts and disbursements basis, from such monthly summaries. No audit was made to determine the accuracy of the "ins" and "outs" reported on the summaries, and petitioner's accountant stated that there was no method of verifying the total amounts received and paid out by petitioner. The total "ins," the total "outs," the gross profit and the percentage of gross profit to "ins," for the year 1946, according to such monthly summaries and petitioner's return for that year, are as follow:

Total Ins	$793,287.50
Total Outs	750,069.85
Gross Profit	$ 43,217.65
Percentage of Profit	5.45

[fol. 60] Petitioner's records for March 16, 1946, were stipulated to be typical of his records for the entire year 1946. The records for this one day disclose that, in two instances, the winning tickets bore a notation indicating only a bet to "win" or a bet to "place," where as the 20-line sheets indicated that these two bets had been made for both "win" and "place." Payments on such bets were made according to the 20-line sheets.

In the statutory notice of deficiency, respondent made no change in the reported "ins." Respondent, however, increased petitioner's reported gross profit by $48,019.41 by disallowing a portion of the claimed "outs." This increased the percentage of gross profit on total receipts from 5.45 per cent to 11.5 per cent.

At pari-mutuel racing tracks throughout the United States, an amount ranging from 10 to 17 per cent of all bets placed is deducted for the benefit of the racing association and the tax authorities. The remaining 90 to 83 per cent of the amounts bet is distributed to winning bettors. Under the laws of Illinois for the year 1946, either 88½ or 87½ per cent of the amounts bet at pari-mutuel tracks was distributed to winning bettors, depending upon the location of the race track.

The services performed by petitioner's employees in return for wages constituted a violation of section 336 of the Criminal Code of the State of Illinois, and the payment of the wages, in and of itself, constituted an illegal act.

Petitioner overstated the amounts paid out to winning bettors by $5,000 on his return for the year 1946.

Opinion

Rice, *Judge*: This is another in a long series of cases involving the question of whether a bookmaker had accurately reported the income derived from his illegal gambling business. As in many of the previous cases, the respondent does not contest the accuracy of the gross receipts and operating expenses reported by the taxpayer, but has determined that the taxpayer overstated the wagering losses realized in his business and, consequently, understated his income. The first issue which we must decide, therefore, is whether petitioner is entitled to claim as a deduction the amounts shown on his records as having been [fol. 61] paid to winning bettors, in computing the income earned from his bookmaking business in 1946.

In the instant case, the petitioner has supposedly maintained and preserved for the respondent's inspection a complete file of his original records. These records, more specifically, the 20-line sheets, do not identify any of the bettors, but they seem to contain an accurate listing of the amounts received and the amounts paid out with respect to every bet. Daily and monthly summaries of these 20-line sheets were compiled, and, on the basis of such summaries, petitioner's return for the year here in issue was prepared. The mathematical accuracy of such summaries, and of petitioner's return, has not been questioned.

Petitioner's records and income tax return disclose total receipts from wagers amounting to $793,287.50 in 1946, and a gross profit on such wagers of approximately 5½ per cent Respondent contends that since approximately 11½ per cent of the amounts wagered at pari-mutuel tracks in Illinois is retained for the benefit of the racing association and the State, and since the amount retained at pari-mutuel tracks throughout the United States ranges from 10 to 17 per cent of all bets placed, petitioner's re-

ported gross profit for the year 1946 should have been 11½ per cent of the total wagers received. Therefore, in order to increase petitioner's gross profit from 5½ per cent to 11½ per cent, respondent has determined that petitioner overstated the amounts paid out to winning bettors in the aggregate amount of $48,010.41.

The essence of respondent's argument is that petitioner must be presumed to have paid between 35 and 50 per cent of his net profits for protection from police interference with his illegal activities. Respondent contends that such nondeductible expenses must have been entered and concealed on petitioner's books by entering fictitous losses and by padding the amounts paid to winning bettors, thus resulting in a gross profit of but 5½ per cent. Respondent has, therefore, disallowed the deduction of $48,010.41 of the wagering losses claimed by petitioner for lack of substantiation.

Respondent introduced the testimony of the Chief Investigator for the Chicago Crime Commission, an independent citizens' organization, to the effect that bookmakers cannot operate in Chicago unless they pay for protection. However, petitioner was unequivocal in his testimony that he did not make any payments for [fol. 62] protection. The fact that other gamblers in Chicago may have been required to do so is of no evidentiary force with respect to any such payments made by petitioner. We do not know what petitioner's relations with the "criminal syndicate" were or why he may have been able to remain in business without paying for protection. But, in any event, the record indicates that petitioner's activities were not completely free from police interference. His wagering establishment was raided several times and petitioner was compelled to change his location and even operate from alleyways and a garage during the year 1946. We have consequently been unable to find as a fact that petitioner made any protection payments during that year.

We recognize the difficulties facing respondent in attempting to audit the records of a taxpayer who is engaged in an illegal business and where the identity of his customers is not ascertained and recorded. Petitioner's own accountant testified that there was no way in which the accuracy of the 20-line sheets could be verified as to the amounts received from and the amounts paid out to bet-

tors. Moreover, petitioner's records were susceptible of easy manipulation. Lines on the 20-line sheets could be left blank until the end of the day, and, after all the races had been run, petitioner could then enter fictitious bets on losing horses and retain such fictitious losses for his own personal use. In addition, since no control was maintained over the sequence in which the alphabetically and numerically coded 20-line sheets were used, those sheets disclosing few or no losses could be removed from the file of petitioner's records and the net receipts disclosed by such sheets could be pocketed by petitioner.

Our system of income tax collection relies on individual self-assessment. Taxpayers are required to file returns setting forth their income, their deductions, and a self-computed tax. The self-assessment system would be unworkable unless means were provided whereby the accuracy of the self-determined tax could be checked. The Regulations,[1] therefore, provide that each individual must [fol. 63] keep such books and records as are sufficient to establish the individual's gross income. The mere mathematical accuracy of such records is insufficient; they must clearly reflect the taxpayer's income.

The issue of whether petitioner's records accurately reflect his income for the year 1946 is one of fact, to be decided on the basis of all the evidence in the record. *Jack Shouse*, 23 T. C. 495 (1954), on appeal C. A. 9, March 9, 1955. Respondent contends that, since petitioner's records do not permit the verification of the various payments made to winning bettors, he may determine the amount of

---

[1] Regulations 111.

Sec. 29.54-1. Records and Income Tax Forms.—Every person subject to the tax, except persons whose gross income (1) consists solely of salary, wages, or similar compensation for personal services rendered, or (2) arises solely from the business of growing and selling products of the soil, shall, for the purpose of enabling the Commissioner to determine the correct amount of income subject to the tax, keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of the gross income and the deductions, credits, and other matters required to be shown in any return * * *.

deductions permitted to petitioner for such unsubstantiated expenditures under the rule of *Cohan* v. *Commissioner*, 39 F. 2d 540 (C. A. 2, 1930). However, although petitioner has failed to carry his burden of proving that the total amount claimed to have been paid to winning bettors was, in fact, so paid, we find respondent's determination of such amount to be excessive. Respondent has determined that $48,010.41 of the losses claimed by petitioner must be disallowed because his reported gross profit amounted to but 5½ per cent whereas the pari-mutuel machines in the State of Illinois operated on a gross profit of 11½ or 12½ per cent, depending upon their location. But, petitioner's winnings or losses have no relation whatsoever to the amount retained out of bets placed at pari-mutuel tracks. The evidence shows a lack of relation between the percentage of winnings in the petitioner's business and the amount retained at pari-mutuel tracks. The amount retained out of bets placed at such tracks is a mathematical amount established by law. The elements of chance and skill have but slight effect on the profits earned by such tracks. They could rarely lose, whereas petitioner might easily suffer substantial net losses from a day's betting if he accepted a disproportionate number of bets on winning horses. *Cf. H. T. Rainwater*, 23 T. C. 450 (1954). The mere suspicion on the part of the Commissioner that the petitioner's records do not accurately reflect his correct income is not sufficient reason to justify adoption of the Commissioner's percentage of winnings in the face of the evidence in this case which shows it is excessive.

The parties have stipulated that petitioner's records for one day during the year 1946 are to be considered typical of his records for that entire year. The records for that day, as submitted into evidence, disclose that in at least two instances the amounts entered on the 20 line sheets as having been paid to winning bettors were larger in amount [fol. 64] than the amounts properly payable for such bets according to the betting tickets. Petitioner failed to explain such discrepancies adequately and, thus, to overcome respondent's determination that his claimed losses were overstated. On the basis of this record and bearing heavily on the petitioner, who failed to keep records with adequate controls and information subject to verification, *And*

Shargel, supra, we have found as a fact that petitioner overstated his deduction for wagering losses on his return for 1946 by the amount of $5,000. *Cohan v. Commissioner, supra*.

The second issue herein is whether petitioner is entitled to deduct, as ordinary and necessary business expenses, wages amounting to $14,563.84 which he paid to the various employees who aided him in the conduct of his illegal bookmaking business during 1946. In his deficiency notice, respondent has allowed the deduction of the various operating expenses claimed by petitioner except for the wages here in issue. Respondent contends that these wages are the "illegitimate expenses of an illegitimate business" and that to allow their deduction would frustrate sharply-defined public policy.

It has long been accepted that certain deductions are not allowable for public policy reasons, although there is no specific provision in the Code or Regulations to that effect. Thus, deductions have been denied for fines and penalties incurred for violation of Federal and State statutes, *Burroughs Bldg. Material Co. v. Commissioner*, 47 F. 2d 178 (C. A. 2, 1931); *Great Northern Ry. Co. v. Commissioner*, 40 F. 2d 372 (C. A. 8, 1930), certiorari denied 282 U. S. 855 (1930); *Julian Lentin*, 23 T. C. 112 (1954), affd. ——— F. 2d ——— (C. A. 7, October 14, 1955); *Joseph Saltzman*, 21 T. C. 777 (1954); *Henry Watterson Hotel Co.*, 15 T. C. 902 (1950), affd. 194 F. 2d 539 (C. A. 6, 1952); for bribes paid to public officials, *Frank A. Maddas*, 40 B. T. A. 572 (1939), affd. 114 F. 2d 548 (C. A. 3, 1940); for expenses incurred for certain types of lobbying engaged in to influence Federal legislation, *Textile Mills Corp. v. Commissioner*, 314 U. S. 326 (1941); and for legal expenses incurred in connection with the unsuccessful defense of criminal actions, *C. B. Thomas*, 16 T. C. 1417 (1951); *Anthony Carmen Stralla*, 9 T. C. 801 (1947).

The frustration of public policy rule has served as the basis for the disallowance of loss deductions under section [fol. 65] 23 (e) and 23 (f) as well as the disallowance of "ordinary and necessary" business expenses under section 23 (a) (1) (A). Thus, in a recent decision, a foreign corporation doing business within the United States was refused a loss deduction, on public policy grounds, for property

which had been vested with the Attorney General as enemy alien property under the Trading with the Enemy Act. *U. S.* v. *Algemene Kunstzijde Unie, N. V.*, ——— F. 2d ——— (C. A. 4, September 19, 1955). In *G. E. Fuller*, 20 T. C. 308 (1953), affd. 213 F. 2d 102 (C. A. 10, 1954), a loss deduction was denied for merchandise confiscated by the State because it had been illegally held for sale.

It has frequently been stated that, where fines and penalties are involved, their deduction as ordinary and necessary business expenses must be disallowed, for to do otherwise would have the effect of possibly frustrating governmental policies by reducing the impact of the penalty. See *Commissioner* v. *Longhorn Portland Cem. Co.*, 148 F. 2d 276 (C. A. 5, 1945), certiorari denied 326 U. S. 728 (1945); *Dauenshire, Inc.* 12 T. C. 958 (1949). Another line of cases in this area states the rule that though some business expenditures may be "ordinary and necessary" in the generally accepted meanings of these words, when they violate Federal or State law, thus frustrating sharply defined National or State policies proscribing particular types of conduct, they are not deductible as ordinary and necessary expenses under section 23 (a) (1) (A) of the 1939 Code. *Gallatin Farmers Co.* v. *Commissioner*, 132 F. 2d 706 (C. A. 9, 1942); *Boyle, Flagg & Seaman, Inc.*, 25 T. C. ——— (Filed October 18, 1955). See *Israel Silberman*, 44 B. T. A. 600 (1941); *Easton Tractor & Equipment Co.*, 35 B. T. A. 189 (1936); *Lorraine Corporation*, 33 B. T. A. 1158, 1166 (1936). As stated in *National Brass Works* v. *Commissioner*, 182 F. 2d 526, 530 (C. A. 9, 1950): "It is true that neither the tax statute nor the treasury regulations condition deductibility upon the lawful character, either directly or remotely, of the expenditure made. * * * But, in the nature of things, public policy must narrow the field of allowable deductions which rest as they do upon legislative indulgence." In two cases which have been before the Supreme Court, that Court has indicated its acceptance of this principle although, in both of these cases, no violation of a clearly defined public policy was found to exist. See *Lilly* v. *Com-*
[fol. 66] *missioner*, 343 U. S. 90 (1952); *Commissioner* v. *Heininger*, 320 U. S. 467 (1943).

This Court has previously considered the question of whether one engaged in an illegitimate business may deduct

the legitimate expenses of such business and, on the facts of that case, held that such expenses were deductible, *G. A. Comeau*, 10 T. C. 203 (1948), affirmed sub nom. *Cohen v. Commissioner*, 176 F. 2d 394 (C. A. 10, 1949). However, the fact that an expenditure is directly related to the production of income does not automatically qualify it as deductible. Where the expense itself is inherently contrary to public policy its deduction must be disallowed. Although both the instant case and *G. A. Comeau*, *supra*, involve the deductibility of wages paid to employees in an illegal bookmaking establishment, the instant case is clearly distinguishable. The record in this case establishes that the payments in question constituted the illegitimate expenses of an illegitimate business, whereas no such finding of fact was made in *G. A. Comeau*, *supra*.

Section 336 of the Criminal Code of the State of Illinois, as quoted below, not only makes the conduct of a bookmaking establishment illegal but also provides that employees who assist in the conduct of such business by recording bets are equally guilty of the commission of an illegal act.

> Illinois Revised Statutes 1945 (Burdette Smith).
>
> 336. * * * That any person who keeps any room, shed, tenement, tent, booth or building, or any part thereof, or who occupies any place upon any public or private grounds within this State with any book, instrument or device for the purpose of recording or registering bets or wagers, or of selling pools, or any person who records or registers bets or wagers, or sells pools upon the result of any trial or contest of skill, speed or power of endurance of man or beast, or upon the result of any political nomination, appointment or election, or being the owner, lessee or occupant of any room, shed, tenement, tent, booth or building, or part thereof, knowingly permits the same to be used or occupied for any of these purposes, or therein keeps, exhibits or employs any device or apparatus for the purpose of recording or registering such bets or wagers, or selling of such pools, or, becomes the [fol. 67] custodian or depository for hire or privilege, of any money, property, or thing of value staked, wagered or pledged upon any such result, shall be punish-

able by imprisonment in the county jail for a period not longer than one year, or by fine not exceeding $2,000 or both. Provided, however, that the provisions of this act shall not apply to the actual enclosure or fair or race track associations that are incorporated under the laws of this state, during the actual time of the meetings of said associations, or within twenty-four hours before any such meetings.

In addition, section 582 of the Criminal Code of the State of Illinois provides as follows:

Illinois Revised Statutes 1945 (Burdette Smith).

582. * * * §2. An accessory is he who stands by, and aids, abets or assists, or who not being present, aiding, abetting or assisting, hath advised, encouraged, aided or abetted the perpetration of the crime. He who thus aids, abets, assists, advises or encourages, shall be considered as principal, and punished accordingly.

Pursuant to these sections of the Criminal Code of the State of Illinois, the payment of the wages in question in and of itself constituted an illegal act. The wages paid by petitioner were paid to procure the direct aid of others in the perpetration of an illegal act, namely, the operation of a bookmaking establishment. Certainly, it would be a clear violation of public policy to permit the deduction of an expenditure, the making of which constitutes an illegal act.

We recognize that the disallowance of the instant expenditure may be almost tantamount to taxing petitioner on his gross rather than his net income. But it is axiomatic that deductions are a matter of legislative grace. *New Colonial Co.* v. *Helvering*, 292 U. S. 435 (1934); *Deputy* v. *du Pont*, 308 U. S. 488 (1940); *Detroit Edison Co.* v. *Commissioner*, 131 F. 2d 649 (C. A. 6, 1942), affd. 319 U. S. 98 (1943). Whether a taxpayer's business is a legal or an illegal one, it is inconceivable that he should be permitted a deduction for amounts spent to procure the commission of an act outlawed by a State statute. We, therefore, hold

that petitioner is not entitled to deduct the wages paid to his employees during the year 1946.

Reviewed by the Court.

Decision will be entered under Rule 50.

[fol. 68] DISSENTING OPINION

MURDOCK, *J.*, dissenting: Many cases involving income and deductions of illegal businesses come before the Court, but this is the first one to my knowledge in which the Commissioner has disallowed a deduction for wages of regular employees claimed by an employer who is engaged in an illegal business. The Commissioner in many cases refuses to accept the net income shown on the books and records of an illegal business because the petitioner has destroyed the original records and the Commissioner has no way of verifying the accuracy and completeness of the books. The Commissioner here has disallowed the salaries of employees who made the original records which the Commissioner properly deems essential to a complete set of records and upon which he has relied in determining the total amounts bet. The Court is supporting him in this, and thus the expense of keeping the very records which are essential to a correct reflection of incor . is denied as an ordinary and necessary expense of the business.

These employees are engaged in the perpetration of the same crime through which the principal earns the income in question. Their wages, like rent, heat, light, telephone and supplies, such as paper and pencils, are inherent expenses of the business, indispensable to the earning of the income in question. Rent and telephone expense would fall into the same category as these wages, if the landlord and the telephone company knew that gambling was conducted on the premises. To deny such deductions is to tax, to that extent, gross income. *G. A. Comeaux*, 10 T. C. 201, 207, affd. 176 F. 2d 394. *Cf. Commissioner* v. *Heininger*, 320 U. S. 467. Wages of real employees are different from bribes in that the giving of a bribe is a separate offense from the conduct of the illegal business. *G. A. Comeaux*, *supra*.

The allowance for wages should be the same in every

state, but here the deduction is being disallowed because of a specific statute of the State of Illinois.

I think the deduction should be allowed.

TIETJENS and ATKINS, *JJ.*, agree with this dissent.

[fol. 69] THE TAX COURT OF THE UNITED STATES

DECISION—Entered Feb. 9, 1956

Pursuant to the determination of this Court, as set forth in its Findings of Fact and Opinion filed December 16, 1955, the respondent filed a computation for entry of decision on February 2, 1956. The petitioner having noted his acquiescence therein, it is

Ordered and Decided: That there is a deficiency in income tax for the taxable year 1946 in the amount of $10,887.77.

(Signed) Stephen E. Rice, Judge. (Seal.)

Entered Feb. 9, 1956.

IN THE UNITED STATES COURT OF APPEALS

(Caption—50868)

PETITION FOR REVIEW (MESI CASE)—Filed Apr. 24, 1956

The petitioner on review, Sam Mesi, hereby petitions the United States Court of Appeals for the Seventh Circuit to review the decision entered by the tax court of the United States on the 9th day of February, 1956, ordering and deciding that there is a deficiency for the year 1946 in respect of the income tax liability of Sam Mesi who is the above named petitioner on review.

Sam Mesi is an individual taxpayer who filed his income tax return for the year 1946, the taxable year here involved, with the Collector of Internal Revenue for the First District of Illinois, whose office is located within the jurisdiction of the United States Court of Appeals for the Seventh Circuit, wherein this review is sought.

The petition for review was filed pursuant to the pro-

visions of Sections 7482 and 7483 of the Internal Revenue Code of 1954.

Dated this 19th day of April, 1956.

Howard R. Slater, Attorney for Petitioner on Review, 134 N. LaSalle St., Chicago 2, Illinois.

[fol. 70] IN THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

[Title omitted]

STATEMENT OF POINTS

Now comes Sam Mesi, Petitioner on Review, by his attorney, Howard R. Slater, and makes the following statement as grounds for and in support of his Petition for Review by the United States Court of Appeals for the Seventh Circuit of the decision of the Tax Court of the United States rendered in the above entitled cause on February 9, 1956, and hereby asserts the following errors which he intends to urge on review:

The Tax Court of the United States erred in the following respects:

(1) In holding and deciding that there is a deficiency in income tax for the taxable year of 1946 in the amount of $10,887.77.

(2) In failing to order and decide that there is no deficiency in income taxes of the Petitioner on Review for the taxable year 1946.

(3) In holding and deciding that the rentals paid by the Petitioner on Review for the use and occupancy of various leased premises for the acceptance of wagers, and the wages paid employees employed by the taxpayer in the operation of a "handbook"—a gambling establishment—did not constitute allowable deductions under Section 23 (a) (1) (A) of the Internal Revenue Code of 1939.

(4) In holding and deciding that the payments made for rents and wages contravene public policy and that the allowance of them would frustrate public policy and

are contrary to the law and regulations promulgated thereunder.

(5) In failing to hold and decide that the payments made for wages are ordinary and necessary in that the [fols. 71-72] taxpayer was compelled to hire employees in order to maintain the records demanded of him for the purposes of making and declaring a correct income tax return pursuant to Section 54 of the Internal Revenue Code of 1939.

(6) In that in its decision and opinion the Tax Court disregarded the overwhelming weight of the evidence which clearly reflected that the taxpayer had correctly represented the gross receipts received by him from wages and the gross disbursements made by him to winning wagerers.

(7) In holding and deciding that the Petitioner on Review overstated his deduction for wagering losses on his income tax return for 1946 by the amount of $5,000.00.

(8) In holding and deciding that the rule of *Cohan* v. *Commissioner* applies to disbursements made for wagering losses.

(9) In failing to hold and decide that the books and records maintained by the Petitioner on Review for the year 1946 substantially and correctly reflected the results from his operations of a gambling establishment during the year 1946.

(10) In that its opinion and decision are not supported by, but are contrary to, the evidence and the facts as shown by the record of the trial hereof.

(11) In that its decision and opinion are contrary to law and the Commissioner's regulations.

Respectfully submitted, Howard R. Slater, Attorney for Petitioner on Review, 134 N. LaSalle St., Chicago, Illinois.

[fol. 73] Clerk's Certificate to foregoing Transcript (omitted in printing).

[fol. 74] In the United States Court of Appeals for the Seventh Circuit, September Term, 1956, January Session, 1957

No. 11775

Sam Mesi, Petitioner,

v.

Commissioner of Internal Revenue, Respondent

On Petition for Review of the Decision of the Tax Court of the the United States

Opinion—April 5, 1957

Before Duffy, Chief Judge, and Swaim and Schnackenberg, Circuit Judges

Schnackenberg, Circuit Judge:

Sam Mesi, hereinafter referred to as the taxpayer, by his petition asks us to review a decision of the tax court which decided that there is a deficiency in his income tax for the year 1946 in the amount of $10,887.77. The tax court made findings of fact and rendered an opinion.[1]

During the year 1946, taxpayer was engaged in the business of accepting wagers on horse races, commonly known as bookmaking. He had a principal location for which he paid an annual rental. Incoming bets totaled $793,287.50 in 1946. He employed 6 or 7 persons during that year, paying them gross wages in the amount of $14,563.84. Among these employees were a cashier, 2 or 3 sheet writers who accepted and entered the incoming bets, men on the "hard cards," and a doorman. The total ins, [fol. 75] the total outs, the gross profit and the percentage of gross profit to ins, for the year 1946, according to monthly summaries kept by the taxpayer and his return for that year are as follows:

Total ins	$793,287.50
Total outs	750,069.85
Gross Profit	$ 43,217.65
Percentage of Profit	5.45

[1] Reported in 25 T.C. 513.

As interpreted by respondent, the tax court determined "that the wages paid to employees in taxpayer's illegal gambling enterprise were not deductible since the payment of the wages violated the criminal statutes of Illinois and the deduction of such wages would tend to frustrate the declared public policy of that state."

The tax court disallowed $5,000 of the betting losses claimed by the taxpayer.

1. The tax court erroneously failed to allow as deductions wages proved to have been paid by taxpayer to his employees in carrying on his business. We so held in *Commissioner of Internal Revenue* v. *Doyle*, 231 F.2d 635, affirming the tax court's memorandum decision, P-H T.C. Memo 54,340; and *Sullivan* v. *Commissioner*, No. 11841; *Ross* v. *Commissioner*, No. 11842, decided February 13, 1957, F. 2d . It is therefore necessary for us to, and we do, reverse the decision of the tax court to that extent.

2. A part of the judgment of the tax court rests upon its finding of fact that taxpayer overstated his deduction for wagering losses on his return in the amount of $5,000. As to how this figure was arrived at, the record does not fully disclose.

While respondent determined that $48,010.41 of the losses claimed by taxpayer must be disallowed because his reported gross profit amounted to but 5½% whereas the pari-mutuel machines in the state of Illinois operated on a gross profit of 11½ or 12½ per cent, depending upon their location, the tax court discarded this ground for disallowance as being not justified.

The tax court found that the parties have stipulated that petitioner's records for one day[2] during the year 1946 are [fol. 76] to be considered typical of his records for that entire year. There is no written stipulation to this effect in the record. We have examined large parts of the colloquy of counsel upon the trial before the tax court and we are unable to find a clear stipulation to that effect. Upon what, if anything, the counsel agreed, is vague and elusive. The briefs in this court do not clarify the subject.

[2] March 16, 1946.

In the notice of deficiency furnished by respondent to the taxpayer, it is stated that the excess of "gaming receipts over gaming disbursements, or gross receipts reported by you in your income tax return for the taxable year 1946 in the amount of $43,217.65 has been increased by [*sic*] $48,010.41 *on the basis of information on file in the Bureau* * * *." (Italics supplied.) The record does not show what this information was. It is axiomatic that a judgment of the court cannot rest upon facts not presented to it.

It follows that, as to the disallowance of $5,000 of taxpayer's betting losses, the decision of the tax court must be, and it is hereby, reversed and the cause remanded to that court for further proceedings in reference to that subject only.

REVERSED IN PART AND REMANDED IN PART, FOR FURTHER PROCEEDINGS.

[fol. 77] UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

No. 11775

SAM MESI, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Petition for Review of a Decision of the Tax Court of the United States

JUDGMENT—April 5, 1957

This cause came on to be heard on the transcript of the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this Court that the decision of the Tax Court of the United States entered in this cause on February 8, 1956 be, and the same is hereby, REVERSED in part REMANDED in part to the said Tax Court of the United States for further pro-

ceedings in accordance with the opinion of this Court filed this day.

[fol. 78] Clerk's Certificate to foregoing Transcript (omitted in Printing).

[fol. 79] SUPREME COURT OF THE UNITED STATES, OCTOBER TERM, 1956

No. 983

COMMISSIONER OF INTERNAL REVENUE, Petitioner,

vs.

NEIL SULLIVAN, GRACE SULLIVAN, JAMES ROSS et al.

ORDER ALLOWING CERTIORARI—Filed June 17, 1957

The petition herein for a writ of certiorari to the United States Court of Appeals for the Seventh Circuit is granted. The case is transferred to the summary calendar and assigned for argument immediately following Nos. 862 and 932.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

Office-Sup... Court, U. S.
F... D
MAY ... 1957
JOHN T. FEY, Clerk

LIBRARY
SUPREME COURT, U. S.

No. ~~983~~ 119

In the Supreme Court of the United States

OCTOBER TERM, 1956

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

NEIL SULLIVAN AND GRACE SULLIVAN

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JAMES ROSS AND ANN ROSS

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SAM MESI

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

J. LEE RANKIN,
Solicitor General,
CHARLES K. RICE,
Assistant Attorney General,
MEYER ROTHWACKS,
Attorney,
Department of Justice, Washington 25, D. C.

INDEX

	Page
Opinions below	2
Jurisdiction	2
Question presented	2
Statutes involved	3
Statement	5
Reasons for granting the writ	9
Conclusion	15
Appendix	16
Opinion below in *Sullivan* and *Ross* cases	16
Judgment in *Sullivan* case	19
Judgment in *Ross* case	20
Opinion below in *Mesi* case	21
Judgment in *Mesi* case	24
Opinion in *Commissioner* v. *Doyle*, 234 F. 2d 635	25

CITATIONS

Cases:

Commissioner v. *Doyle*, 231 F. 2d 635	11, 13, 25
Commissioner v. *Heininger*, 320 U. S. 467	10, 14
Fazzio v. *Commissioner*, decided September 7, 1943	12
Fuller v. *Commissioner*, 213 F. 2d 102	11
Giubbini v. *Commissioner*, decided October 27, 1939	12
Great Northern Railway Co. v. *Commissioner*, 8 B. T. A. 225, affirmed, 40 F. 2d 372, certiorari denied, 282 U. S. 855	13
Harden McLean Co. v. *Commissioner*, 137 F. 2d 282	11
Hoover Motor Express Co., Inc. v. *United States*, 241 F. 2d 459, pending on petition for a writ of certiorari, No. 862, this Term	13, 14
Humphreys v. *Commissioner*, 125 F. 2d 340, certiorari denied, 317 U. S. 637	11
Kärger, Estate of v. *Commissioner*, decided July 13, 1954	12

Cases—Continued

	Page
Kelley-Dempsey & Co. v. *Commissioner*, 31 B. T. A. 351	12
Lentin v. *Commissioner*, 226 F. 2d 695, certiorari denied, 350 U. S. 934	11
Lilly v. *Commissioner*, 343 U. S. 90	9, 10, 14
Reliable Milk & Cream Co., Inc. v. *Commissioner*, decided August 20, 1938	12
Rugel v. *Commissioner*, 127 F. 2d 393	11
Standard Oil Co. v. *Commissioner*, 129 F. 2d 363, certiorari denied, 317 U. S. 688	11
Tank Truck Rentals, Inc. v. *Commissioner*, decided March 6, 1957 (C. A. 3d), pending on petition for a writ of certiorari, No. 932, this Term	13, 14
Terminal Railroad Assn. of St. Louis v. *Commissioner*, 17 B. T. A. 1135, affirmed, *sub nom. Tunnel R. R. of St. Louis* v. *Commissioner*, 61 F. 2d 166, certiorari denied, 288 U. S. 604	13
Textile Mills Corp. v. *Commissioner*, 314 U. S. 326	10
United States v. *Algemene Kunstzijde Unie, N. V.*, 226 F. 2d 115, certiorari denied, 350 U. S. 969	11
United States v. *Sullivan*, 274 U. S. 259	9
Statutes:	
Internal Revenue Code of 1939, Sec. 23 (a) (26 U. S. C. 1952 ed., Sec. 23 (a))	3, 14
Illinois Revised Statutes (1945), c. 38 (Criminal Code):	
Sec. 139	3
Sec. 140	4
Sec. 336	4, 6, 8
Sec. 582	5, 6, 7
Miscellaneous:	
4 Mertens, *Law of Federal Income Taxation*, Secs. 25.131-25.135	12
Rule 23 (5):	
Revised Rules of the Supreme Court of the United States, effective July 1, 1954	1

In the Supreme Court of the United States

OCTOBER TERM, 1956

No. —

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

NEIL SULLIVAN AND GRACE SULLIVAN

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JAMES ROSS AND ANN ROSS

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SAM MESI

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgments of the Court of Appeals for the Seventh Circuit in these cases involving substantially identical questions (Rule 23 (5)).

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court in the *Sullivan* and *Ross* cases (*Sullivan* R. 5–19)[1] are not officially reported. The opinion of the Court of Appeals in those cases (Appendix, *infra*, pp. 16–18) is reported at 241 F. 2d 46. The Tax Court's findings of fact and opinion in the *Mesi* case (*Mesi* R. 56–68) are reported at 25 T. C. 513. The opinion of the Court of Appeals in the *Mesi* case (Appendix, *infra*, pp. 21–23) is not yet reported.

JURISDICTION

The judgments of the Court of Appeals in the *Sullivan* and *Ross* cases (Appendix, *infra*, pp. 19, 20) were entered on February 13, 1957. The judgment of the Court of Appeals in the *Mesi* case (Appendix, *infra*, p. 24) was entered on April 5, 1957. The jurisdiction of this Court is invoked under 28 U. S. C. 1254.

QUESTION PRESENTED

The taxpayers, while conducting gambling establishments, made certain payments for the rental of the premises and for the wages of their employees. These payments were prohibited by the criminal statutes of the State of Illinois.

The question is whether such payments, made in violation of State law, are deductible under the Inter-

---

[1] References designated "*Sullivan* R. " are to the appendix to the taxpayers' brief in the Court of Appeals in the *Sullivan* and *Ross* cases. References designated "*Mesi* R. " are to the separately printed record in the Court of Appeals in the *Mesi* case.

nal Revenue Code of 1939, Section 23 (a) (1) (A), as ordinary and necessary expenses incurred in carrying on a trade or business.

STATUTES INVOLVED

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income, there shall be allowed as deductions:

(a) [as amended by Sec. 121 (a), Revenue Act of 1942, c. 619, 56 Stat. 798, 819] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In general.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * * and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(26 U. S. C. 1952 ed., Sec. 23 (a).)

Illinois Revised Statutes (1945), c. 38 (Criminal Code):

CONSPIRACY

* * * * *

139. *To do an illegal act—Boycott—Black list.* § 46. If any two or more persons conspire or agree together, * * * to do any illegal act injurious to the public trade, health, morals, police, or administration of public justice, * * * they shall be deemed guilty of a conspiracy;

and every such offender, * * * and every person convicted of conspiracy at common law, shall be imprisoned in the penitentiary not exceeding five years, or fined not exceeding $2,000, or both.

* * * * * *

, 140. *Against state, etc.* § 1. * * * That if two or more persons conspire either to commit any offense against the State of Illinois, or any county, incorporated city, village, town or township thereof, * * * in any manner, or for any purpose, and one or more of such parties, do any act to effect the object of the conspiracy, all parties to such conspiracy shall be liable to a penalty of not less than one hundred dollars, and not more than five thousand dollars, and to be imprisoned in the pentitentiary for a term of not less than one year nor more than two years or imprisonment in the county jail for any period not exceeding two years. Provided, however, this Act shall not be construed to modify or repeal any other law in force in this State.

GAMBLING AND GAMBLING DEVICES

336. *Book-making and pool-selling unlawful.* § 1. * * * That any person who keeps any room, shed, tenement, tent, booth, or building, or any part thereof, or who occupies any place upon any public or private grounds within this state, with any book, instrument or device for the purpose of recording or registering bets or wagers, or of selling pools, or any person who records or registers bets or wagers, or sells pools upon the result of any trial or contest of skill, speed or power of endurance of man or

beast, or upon the result of any political nomination, appointment or election, or being the owner, lessee or occupant of any room, shed, tenement, tent, booth, or building, or part thereof, knowingly permits the same to be used or occupied for any of these purposes, or therein keeps, exhibits or employs any device or apparatus for the purpose of recording or registering such bets or wagers, or selling of such pools, or becomes the custodian or depository for hire or privilege, of any money, property, or thing of value staked, wagered or pledged upon any such result, shall be punishable by imprisonment in the county jail for a period not longer than one year or by fine not exceeding $2,000 or both. * * *

ACCESSORIES

582. *Before the fact.* § 2. An accessory is he who stands by, and aids, abets or assists, or who not being present, aiding, abetting or assisting, hath advised, encouraged, aided or abetted the perpetration of the crime. He who thus aids, abets, assists, advises or encourages, shall be considered as principal, and punished accordingly.

STATEMENT

Sullivan and Ross cases.—During the years in question the taxpayers, Neil Sullivan and James Ross, were engaged, as equal partners, in accepting wagers on horse races, commonly known as bookmaking, in Chicago, Illinois.[2] (*Sullivan* R. 5.) This bookmaking

[2] Grace Sullivan and Ann Ross are taxpayers by reason of filing joint returns with their husbands.

was illegal under the Criminal Code of Illinois. (*Sullivan* R. 16–17.)

The partnership in the conduct of its bookmaking paid total wages to its six or seven employees and claimed deductions as follows (*Sullivan* R. 12):

Year	Wages
1948	$18,950.00
1949	22,935.00
1950	23,390.00

The services of the employees for these wages were performed in the illegal operation of the partnership, including the recording of bets. (*Sullivan* R. 12.)

The activities were conducted in various leased rooms on the upper floors of a hotel located in the central business district of Chicago. On frequent occasions the locations were raided by the police. The partnership changed its rooms in the hotel from time to time because of such raids. (*Sullivan* R. 7, 11.) The partnership paid rent to the lessor of the various hotel rooms and claimed deductions as follows (*Sullivan* R. 12):

Year	Rent
1948	$8,735.00
1949	9,200.00
1950	9,215.00

The lessor knowingly permitted these rooms to be used for the purposes of bookmaking, and the parties knew that both the payment and receipt of rentals were in violation of Sections 336 and 582 of the Illinois Criminal Code. (*Sullivan* R. 13, 17.)

The acts performed by the employees of the partnership and the lessor in return for the wages received by the former, and the rent received by the latter, constituted violations of Section 336 of the

Criminal Code of the State of Illinois. The payment of the wages and rent constituted a violation of Section 582 of the Code. (*Sullivan* R. 13.)

The Tax Court held that the deduction of wages and rent must be disallowed since to permit the deductions would be a frustration of the declared public policy of Illinois. (*Sullivan* R. 17.)

The Court of Appeals reversed the judgment of the Tax Court. It remanded the cause solely for the redetermination of an issue not before this Court. (Appendix, *infra*, p. 18.)

The Mesi case. During the year 1946, the taxpayer was engaged in accepting wagers on horse races, commonly known as bookmaking. He conducted his gambling operations from three or four different locations at various times during that year. He had a principal location for which he paid an annual rental, but he was compelled to move about because of raids by the police. He operated from a garage and, during certain periods in 1946, in basements, hallways, and alleyways. (*Mesi* R. 57.)

The taxpayer spent little time at his bookmaking establishment during the daytime. He occasionally visited it in the afternoons and usually went there in the evenings when the summaries of the day's activities were being prepared. Although engaged in illegal activities and although his establishment was raided several times during 1946, he was not personally arrested at any time during that year. (*Mesi* R. 57.)

The taxpayer's gambling activities were extensive. Although the great majority of the bets taken were small, being for 50 cents, $1, or $2, and though no bets in excess of $100 were accepted, incoming bets totaled $793,287.50 in 1946. He employed six or seven persons during that year, paying them gross wages in the amount of $14,563.84. Among these employees were a cashier, two or three sheet writers who accepted and entered the incoming bets, men on the "hard cards,"[3] and a doorman. (*Mesi* R. 57–58.)

The services performed by taxpayer's employees in return for wages constituted a violation of Section 336 of the Criminal Code of the State of Illinois, and the payment of the wages, in and of itself, constituted an illegal act. (*Mesi* R. 60, 67.)

The Tax Court, in an opinion reviewed by the whole court, determined that the wages paid to the taxpayer's employees were not deductible for income tax purposes since the payment thereof had been an illegal act under the law of Illinois and had violated a clearly defined and declared public policy of that state. (*Mesi* R. 64–67.)

The Court of Appeals reversed the judgment of the Tax Court and held that the wages paid by the taxpayer were proper deductions. The case was remanded for further proceedings with respect to an issue not raised here. (Appendix, *infra*, p. 23.)

---

[3] The "hard cards" were large cardboard sheets, one for each track, which showed the entries for the day, the jockey, and the probable odds. (*Mesi* R. 58.)

REASONS FOR GRANTING THE WRIT

These cases raise the fundamental question of the deductibility of illegal expenditures under the income tax laws of the United States. In holding illegal payments by gamblers to be "ordinary and necessary" expenses of a "trade or business" the Court of Appeals has decided, adversely to the Government, an important question of federal law which has been explicitly left open by this Court and on which the lower courts have failed to develop a uniform rule.

1. This Court has not yet decided the question of whether payments which constitute a violation of state law or are incidental to such a violation may be considered as ordinary and necessary business expenses, and thus used to reduce the income tax of those making them. In *United States* v. *Sullivan*, 274 U. S. 259, 264, Mr. Justice Holmes, replying to a suggestion that one engaged in the illicit traffic of liquor might be entitled to deduct illegal expenses such as bribery, stated for the Court: "This by no means follows, but it will be time enough to consider the question when a taxpayer has the temerity to raise it." In *Lilly* v. *Commissioner*, 343 U. S. 90, 94–95, the Court again left the question open:

> We do not have before us the issue that would be presented by expenditures which themselves violated a federal or state law or were incidental to such violations. In such a case it could be argued that the outlawed expenditures, by virtue of their illegality, were not "ordinary and necessary" business exp

> penses within the meaning of § 23 (a) (1) (A). [citations omitted]

The issue there left open is presented in these cases. Respondents paid persons to break the law—to run a gambling establishment and to provide space within which it could be run. Respondents contend that these illegal payments, including those which induced persons to commit crimes, may be deducted as the "ordinary and necessary" expenses of carrying on a "trade or business." The court below has so held. The Government disagrees. This is an issue of obvious importance which ought to be resolved by this Court.

2. In *Textile Mills Corp.* v. *Commissioner*, 314 U. S. 326, the Court held that lobbying expenditures of a corporation were properly treated as non-deductible expenses. The Court found that under the statutory standard of "ordinary and necessary" a line could be drawn "between legitimate business expenses and those arising from that family of contracts to which the law has given no sanction." (314 U. S. at 339).

Commissioner v. *Heininger*, 320 U. S. 467, suggested the rule that expenditures might be deducted except where to allow the deduction would frustrate sharply defined national or state policies proscribing particular types of conduct. (320 U. S. at 473–474). This was assumed by the Court to be the law in *Lilly* v. *Commissioner*, *supra*, where the Court stated (343 U. S. at 97):

> The policies frustrated must be national or state policies evidenced by some governmental declaration of them.

Although these decisions are not direct holdings on the question raised in this petition, they indicate a general approach which is different from that followed by the court below.

3. The decisions below are also inconsistent with the reasoning of decisions of those courts of appeals which have followed the "public policy" doctrine in a wide variety of situations.[4] In many of the cases, the expense or loss which was denied deduction was no less an integral part of the taxpayer's activities than are the expenses involved here.[5] For example, see *United States* v. *Algemene Kunstzijde Unie, N. V.*, 226 F. 2d 115 (C. A. 4th), certiorari denied, 350 U. S. 969 (loss incurred by foreign corporation doing business in this country when certain of its assets were vested by the United States under the Trading with the Enemy Act); *Fuller* v. *Commissioner*, 213 F. 2d 102 (C. A. 10th) (loss incurred when whiskey, being sold in a dry state, was confiscated by law enforcement officers); *Rugel* v. *Commissioner*, 127 F. 2d 393 (C. A. 8th) (payments to influential political precinct captain to obtain printing contract); *Harden M. Loan Co.* v. *Commissioner*, 137 F. 2d 282 (C. A. 10th) (payment

---

[4] The decisions in the present cases followed the reasoning of *Commissioner* v. *Doyle* and, for the Court's convenience, the *Doyle* opinion is reproduced in the Appendix, *infra*, pp. 25–32.

[5] The Seventh Circuit's decisions in the instant cases also appear to be inconsistent with its prior decisions in *Lentin* v. *Commissioner*, 226 F. 2d 695, 699, certiorari denied, 350 U. S. 934; *Standard Oil Co.* v. *Commissioner*, 129 F. 2d 363, 371, certiorari denied, 317 U. S. 688; and *Humphreys* v. *Commissioner*, 125 F. 2d 340, 343, certiorari denied, 317 U. S. 637.

for political influence, disguised in the form of sales commissions). There are also many Tax Court decisions which apply the same general principle to deny deductibility of expenses which are contrary to public policy. See, for example: *Giubbini* v. *Commissioner,* decided October 27, 1939 (1939 P-H B. T. A. Memorandum Decisions, par. 39,471) (payments by abortionist to his procurers); *Estate of Karger* v. *Commissioner,* decided July 13, 1954 (1954 P-H T. C. Memorandum Decisions, par. 54,204) (salaries paid to abortionist's assistant); *Kelley-Dempsey & Co.* v. *Commissioner,* 31 B. T. A. 351 (amounts paid as commercial extortion); *Fazzio* v. *Commissioner,* decided September 7, 1943 (1943 P-H T. C. Memorandum Decisions, par. 43,410) (fees paid for membership identification tags on pinball machines where purpose of association was illegal); *Reliable Milk & Cream Co., Inc.* v. *Commissioner,* decided August 20, 1938 (1938 P-H B. T. A. Memorandum Decisions, par. 38,290) (payments to racketeers made under fear of assault). A more complete list of decisions will be found in 4 Mertens, *Law of Federal Income Taxation,* Sections 25.131-25.135.

The public policy doctrine has also served as a basis for disallowing the deduction of fines or penalties incurred through violations of federal and state statutes so as to avoid a frustration of the public policy expressed in these statutes. See 4 Mertens, *supra,* Section 25.131. Of particular significance here are the decisions disallowing the deduction where the violations were inadvertent, unintentional or even

unavoidable in the conduct of the taxpayer's business. *Great Northern Railway Co.* v. *Commissioner,* 8 B. T. A. 225, 234, affirmed, 40 F. 2d 372 (C. A. 8th), certiorari denied, 282 U. S. 855; *Terminal Railroad Assn. of St. Louis* v. *Commissioner,* 17 B. T. A. 1135, 1154–1155, 1169, affirmed, *sub nom. Tunnel R. R. of St. Louis* v. *Commissioner,* 61 F. 2d 166 (C. A. 8th), certiorari denied, 288 U. S. 604; *Hoover Motor Express Co., Inc.* v. *United States,* 241 F. 2d 459 (C. A. 6th), pending on petition for a writ of certiorari, No. 862, this Term; *Tank Truck Rentals, Inc.* v. *Commissioner* (C. A. 3d), decided March 6, 1957 (1957 C. C. H., par. 9466), pending on petition for a writ of certiorari, No. 932, this Term.

We believe that the *Hoover Motor Express* and *Tank Truck Rentals* cases, *supra,* were correctly decided. To the extent, however, that these cases hold that the taxpayers may not deduct fines or penalties resulting from violations of state statutes regulating weight limits of trucks, the decisions appear to us[6] to be out of harmony with the decisions below and the "integral" "concomitant" test which they introduce. That is, where, in the normal conduct of a business, unintentional, inadvertent violations of law occur, such violations would appear to be an integral part of the business, and the rationale employed by the court below would lead to the conclusions that the fines

[6] The court below thought that a distinction could be made between payments of fines, penalties and bribes, which it would consider unnecessary, and illegal payments which were an "integral part of a business". See its opinion in the *Doyl* case, *infra,* at page 29.

ought to be deductible. Consequently, those decisions and the decisions below cannot be fairly reconciled and, concurrently with the filing of the petition in these cases, the Government is filing a memorandum which does not oppose the granting of certiorari on the petitions which have been filed by the taxpayers in the *Hoover Motor Express* and *Tank Truck Rentals* cases.

4. It is the Government's view that the decisions below are erroneous. We do not believe that it is "necessary" to break the law or, in particular, that it is "necessary" to hire persons to commit crimes. The wages found below to be deductible were those paid to induce the employees to engage in criminal conduct. It is also our view that the words "trade or business" as used in Section 23 mean a lawful enterprise and do not cover criminal activities. Certainly one engaged in a legitimate business cannot deduct bribes or other illegal expenditures. Yet, if the court below is right, a taxpayer, by limiting himself exclusively to illegal activities, could convert such non-deductible expenditures into the "ordinary and necessary" expenses of carrying on a "trade or business." Further, we believe that the public policy rule declared by the Court in *Commissioner* v. *Heininger*, 320 U. S. 467, and in *Lilly* v. *Commissioner*, 343 U. S. 90, is applicable here, and that the statute should not be construed to allow deductions which would frustrate sharply defined national or state policies, embodied in criminal statutes, proscribing particular types of conduct.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

J. LEE RANKIN,
Solicitor General.

CHARLES K. RICE,
Assistant Attorney General.

MEYER ROTHWACKS,
Attorney.

MAY 1957.

APPENDIX

	Page
Opinion below in *Sullivan* and *Ross* cases	16
Judgment below in *Sullivan* case	19
Judgment below in *Ross* case	20
Opinion below in *Mesi* case	21
Judgment below in *Mesi* case	24
Opinion in *Commissioner* v. *Doyle*, 231 F. 2d 635	25

In the United States Court of Appeals for the Seventh Circuit

SEPTEMBER TERM, 1956 JANUARY SESSION, 1957

Nos. 11841, 11842

NEIL SULLIVAN AND GRACE SULLIVAN, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

JAMES ROSS AND ANN ROSS, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

PETITIONS FOR REVIEW OF DECISIONS OF THE TAX COURT OF THE UNITED STATES

February 13, 1957.

Before LINDLEY, SWAIM and SCHNACKENBERG, *Circuit Judges.*

SCHNACKENBERG, *Circuit Judge.* Petitioners seek a review[1] of that part of decisions entered by the Tax Court of the United States which determined deficiencies in their income taxes for the years 1948, 1949, and 1950, and imposed penalties therefor. The only contested issue in the cases is whether or not petitioners may deduct for income tax purposes unlawful payments of wages and rent in connection with the unlawful operation in Illinois of a book-making establishment by petitioners Neil Sullivan and James Ross.

This legal issue was presented, argued and decided by this court in *Commissioner of Internal Revenue* v. *Doyle,* 231 F. 2d 635, where the Commissioner himself stated the question there presented to us for decision, in this language: "Whether expenses for rent and wages incurred in the operation of an illegal gambling business are themselves contrary to a sharply defined and declared public policy of the state of Illinois and hence are not deductible for income tax purposes, within the meaning of sec. 23 (a), Internal Revenue Code of 1939. In our opinion, we accepted and decided the question as thus stated. In this case, the Commissioner states the contested issue thus: Whether a taxpayer may deduct for income tax purposes payments of rent and wages which were made in violation of criminal statutes of the state of Illinois.[2] It does not appear that the Commissioner applied to the United States Supreme Court for *certiorari* to review our decision in the *Doyle* case. It does appear that, before a single judge of the Tax Court who tried the

[1] These cases came from the Tax Court on a consolidated record.

[2] In the *Doyle* case, the Commissioner relied on only the following statutes of the state of Illinois: §§ 139, 140, 336 and 582, chapter 38 (Criminal Code) Illinois Revised Statutes, 1945. He relies upon the same statutes in the case at bar.

case at bar, the Commissioner contended and now contends that the holding of this court in the *Doyle* case should not be followed. If the Commissioner feels that the decision in the *Doyle* case was wrong he should have, by application for *certiorari*, afforded the Supreme Court an opportunity to pass upon his contentions. Lacking such a decision by the highest court, a decision by one judge of the Tax Court, which, in effect, overrules a decision of the court of appeals in the circuit in which both cases arose, is not consonant with the responsibilities of the respective tribunals involved. To the same effect is *Stacey Mfg. Co.* v. *Commissioner of Internal Revenue*, 237 F. 2d 605.

Our opinion in the *Doyle* case neither expressly treated, nor by any possible inference can be construed as treating, the wages and rent paid by the taxpayer as "legitimate" expenses. The word "legitimate", upon which the Commissioner now relies in an attempt to disfinguish the *Doyle* case, was used by the Tax Court in its decision in the *Doyle* case, but not by us. We made it clear, at 636, that sec. 23 (a),[3] in setting forth what trade or business expenses are to be deducted from gross income in computing net income, makes no distinction between *lawful* and *unlawful* disbursements.

On the authority of the *Doyle* holding, to which we adhere, the decision of the Tax Court is reversed and the cause is remanded[4] for the sole purpose of a redetermination of the penalties, if any, assessable solely on the basis of income reported by petitioners in their returns.

Reversed and remanded.

---

[3] 26 U. S. C. A. § 23 (a).

[4] 26 U. S. C. A. § 7482.

In the United States Court of Appeals
For the Seventh Circuit

No. 11841

NEIL SULLIVAN AND GRACE SULLIVAN, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

PETITION FOR REVIEW OF A DECISION OF THE TAX COURT OF THE UNITED STATES

Wednesday, February 13, 1957

Before LINDLEY, SWAIM, SCHNACKENBERG, *Circuit Judges.*

This cause came on to be heard on the transcript of the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this Court that the decision of the Tax Court of the United States entered in this cause on March 19, 1956 be, and the same is hereby, *Reversed,* and that this cause be, and the same is hereby, *Remanded* to the said Tax Court of the United States for the sole purpose of a redetermination of the penalties, if any, assessable solely on the basis of income reported by petitioners in their returns, in accordance with the opinion of this Court filed this day.

In the United States Court of Appeals for the Seventh Circuit

No. 11842

JAMES ROSS AND ANN ROSS, PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

PETITION FOR REVIEW OF A DECISION OF THE TAX COURT OF THE UNITED STATES

Wednesday, February 13, 1957

Before LINDLEY, SWAIM, SCHNACKENBERG, *Circuit Judges.*

This cause came to be heard on the transcript of the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this Court that the decision of the Tax Court of the United States entered in this cause on March 19, 1956 be, and the same is hereby, *Reversed*, and that this cause be, and the same is hereby *Remanded* to the said Tax Court of the United States for the sole purpose of a redetermination of the penalties, if any, assessable solely on the basis of income reported by petitioners in their returns, in accordance with the opinion of this Court filed this day.

In the United States Court of Appeals for the Seventh Circuit

SEPTEMBER TERM, 1956 JANUARY SESSION, 1957

No. 11775

SAM MESI, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

April 5, 1957

Before DUFFY, *Chief Judge*, and SWAIM and SCHNACKENBERG, *Circuit Judges*.

SCHNACKENBERG, *Circuit Judge*. Sam Mesi, hereinafter referred to as the taxpayer, by his petition asks us to review a decision of the tax court which decided that there is a deficiency in his income tax for the year 1946 in the amount of $10,887.77. The tax court made findings of fact and rendered an opinion.[1]

During the year 1946, taxpayer was engaged in the business of accepting wagers on horse races, commonly known as bookmaking. He had a principal location for which he paid an annual rental. Incoming bets totaled $793,287.50 in 1946. He employed 6 or 7 persons during that year, paying them gross wages in the amount of $14,563.84. Among these employees were a cashier, 2 or 3 sheet writers who ac-

[1] Reported in 25 T. C. 513.

cepted and entered the incoming bets, men on the "hard cards," and a doorman. The total ins, the total outs, the gross profit, and the percentage of gross profit to ins, for the year 1946, according to monthly summaries kept by the taxpayer and his return for that year are as follows:

Total Ins	$793,287.50
Total outs	750,069.85
Gross Profit	$43,217.65
Percentage of Profit	5.45

As interpreted by respondent, the tax court determined "that the wages paid to employees in taxpayer's illegal gambling enterprise were not deductible since the payment of the wages violated the criminal statutes of Illinois and the deduction of such wages would tend to frustrate the declared public policy of that state."

The tax court disallowed $5,000 of the betting losses claimed by the taxpayer.

1. The tax court erroneously failed to allow as deductions wages proved to have been paid by taxpayer to his employees in carrying on his business. We so held in *Commissioner of Internal Revenue* v. *Doyle*, 231 F. 2d 635, affirming the tax court's memorandum decision, P-H T.C. Memo 54,340; and *Sullivan* v. *Commissioner*, No. 11841; *Ross* v. *Commissioner*, No. 11842, decided February 13, 1957, —— F. 2d ——. It is therefore necessary for us to, and we do, reverse the decision of the tax court to that extent.

2. A part of the judgment of the tax court rests upon its finding of fact that taxpayer overstated his deduction for wagering losses on his return in the amount of $5,000. As to how this figure was arrived at, the record does not fully disclose.

While respondent determined that $48,010.41 of the losses claimed by taxpayer must be disallowed because

his reported gross profit amounted to but 5½%, whereas the pari-mutuel machines in the state of Illinois operated on a gross profit of 11½ or 12½ per cent, depending upon their location, the tax court discarded this ground for disallowance as being not justified.

The tax court found that the parties have stipulated that petitioner's records for one day[2] during the year 1946 are to be considered typical of his records for that entire year. There is no written stipulation to this effect in the record. We have examined large parts of the colloquy of counsel upon the trial before the tax court and we are unable to find a clear stipulation to that effect. Upon what, if anything, the counsel agreed, is vague and elusive. The briefs in this court do not clarify the subject.

In the notice of deficiency furnished by respondent to the taxpayer, it is stated that the excess of "gaming receipts over gaming disbursements, or gross receipts reported by you in your income tax return for the taxable year 1946 in the amount of $43,217.65 has been increased by [*sic*] $48,610.41 *on the basis of information on file in the Bureau* * * *." (Italics supplied.) The record does not show what this information was. It is axiomatic that a judgment of the court cannot rest upon facts not presented to it.

It follows that, as to the disallowance of $5,000 of taxpayer's betting losses, the decision of the tax court must be, and it is hereby, reversed and the cause remanded to that court for further proceedings in reference to that subject only.

Reversed in part and remanded in part, for further proceedings.

---

[2] March 16, 1946.

In the United States Court of Appeals

For the Seventh Circuit

No. 11775

SAM MESI, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Friday, April 5, 1957

Before DUFFY, *Chief Judge*, and SWAIM, and SCHNACKENBERG, *Circuit Judges*.

PETITION FOR REVIEW OF A DECISION OF THE TAX COURT OF THE UNITED STATES

This cause came on to be heard on the transcript of the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this Court that the decision of the Tax Court of the United States entered in this cause on February 9, 1956 be, and the same is hereby, *Reversed* in part *Remanded* in part to the said Tax Court of the United States for further proceedings in accordance with the opinion of this Court filed this day.

In the United States Court of Appeals
For the Seventh Circuit

OCTOBER TERM, 1955 JANUARY SESSION, 1956

No. 11572

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHARLES V. DOYLE AND CLARA DOYLE, RESPONDENTS

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

April 11, 1956

Before MAJOR, FINNEGAN and SCHNACKENBERG, *Circuit Judges.*

SCHNACKENBERG, *Circuit Judge.* This petition for review involves income taxes and penalties of $7,223.75 for 1948, 1949 and 1950, and questions the correctness of a decision of the Tax Court entered on January 26, 1955. The petition was filed by the Commissioner on April 25, 1955, pursuant to sec. 7482 of the Internal Revenue act of 1954.[1]

As expressed in the words of the Commissioner, the question presented is whether expenses for rent and wages incurred in the operation of an illegal gambling business are themselves contrary to a sharply defined and declared public policy of the state of Illinois and hence are not deductible for in-

[1] 28 U. S. C. A., § 7482.

come tax purposes, within the meaning of sec. 23 (a), Internal Revenue Code of 1939.[2]

During the taxable years, the taxpayer, Charles V. Doyle,[3] hereinafter referred to as respondent, was engaged in accepting wagers on horse races, herein referred to as bookmaking or operating a handbook, in the state of Illinois. Respondent paid rent for a room in Chicago where he accepted, recorded and paid the wagers. In the conduct of this business respondent paid wages to several employees.

The Commissioner contends that the Tax Court erred in allowing these amounts to be deducted from the gross income of the respondent.

The blueprint for this decision is to be found in sec. 23 of the Internal Revenue Code of 1939.[4] Relevant provisions thereof read as follows:

> "SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> (a) [as amended by Sec. 121 (a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—
>
> (1) *Trade or business expenses.*—
>
> (A) *In General.* All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * * and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

---

[2] 26 U. S. C. A. § 23 (a).

[3] Clara Doyle is a party by reason of filing joint returns with her husband, the respondent. She will not be further referred to in this opinion.

[4] 26 U. S. C. A. § 23.

Sec. 23 (a), in setting forth what trade or business expenses are to be deducted from gross income in computing net income, makes no distinction between lawful and unlawful disbursements. The act says that there shall be allowed as deductions all ordinary and necessary expenses paid or incurred in carrying on any trade or business, including a reasonable allowance for salaries and rentals for use of property for purposes of the trade or business.

Both parties agree that gross income includes income from a trade or business regardless of its lawfulness or unlawfulness. But the Commissioner would include the element of lawfulness of expenses of rent and salaries of a trade or business as a requirement for their deductibility, in addition to the act's requirement that said expenses be "ordinary and necessary". Here is "clear Congressional action" contrary to the Commissioner's position. *Textile Mills Sec. Corp.* v. *Commissioner*, 314 U. S. 326, at 328. The Commissioner would have us add the word "lawful" in the guise of judicial construction. This is a taxing statute. The congress by this act purposed the raising of revenue rather than the furnishing of aid to the enforcement of the state's criminal laws. In imposing an income tax, the congress draws no distinction between income from a lawful business and income from an unlawful business. It is not concerned with the source.

The language of sec. 23 is clear and unambiguous. Its application to this case requires an affirmance of the Tax Court's decision. However, because of the exhaustive brief filed by the Commissioner, in which he attempts to justify his contention that the Tax Court erred, we shall not end this opinion at this point, but shall discuss the Commissioner's arguments and the principal cases upon which he relies.

In the situation in which we find ourselves, we have no right to let our natural antipathy to respondent, because of the unlawfulness of his business, deter us from objectively applying the law as it is written. Lawful or unlawful, the government has seen fit to impose a tax upon respondent's business. That business, like most businesses, has in-take and out-go. The Commissioner would have us consider that business as divided into three parts: (1) the gross income, (2) the amounts paid for salaries and rent and (3) other expenses of the business. As we shall see, the Commissioner, in computing respondent's income tax, takes into account (1) and (3) and discards (2). This is confusing because (2) is expressly recognized as a proper deduction by sec. 23 (a), and (3) is also recognized, but not specifically. However, the business is not susceptible to the assumed division. The business, whose income the government seeks to tax, is a unit. Its income is as unlawful as any of its ordinary and necessary expenses. They are all integral parts of a whole tree whose fruit the Commissioner would tax. He is inconsistent when he concedes that the following expenses in part (3) are deductible: lights, forms and scratch sheets, repairs, supplies, telephone, wall sheets, armored express, wire service, safety tickets, depreciation, auditing, currency exchange, stationery and printing, laundry, etc., totalling for 1948, $6,909.53, for 1949, $6,615.59, and for 1950, $6,357.43.

From sec. 23 (a) we find that an allowable deduction claimed for an expense in carrying on a business must be ordinary and necessary, nothing more or less. In what amounts to a partial recognition that this is true, the Commissioner admits as proper deductions respondent's expenses for telephone, printing and other items; none of them specifically mentioned in the act.

It is clear that salaries and rent are ordinary and necessary to the carrying on of the business of a handbook just as the admitted expenses are. Moreover, the act specifically mentions salaries and rent. Economically they are as much as integral part of the business as is the receipt by the handbook operator of moneys paid on bets.

We construe the statutory words "ordinary and necessary expenses" to mean those expenses which economically are an integral part of a business, whether it be lawful or unlawful. Integrality is the test. Disbursements which fail to meet this test, although they may be concomitants to the business as operated by some persons, are not ordinary and necessary expenses thereof within the meaning of sec. 23(a). We exclude and, therefore, hold as non-deductible, expenses which are not an integral part of a business. In this class fall bribes paid to public officers,[1] fines and penalties imposed for violations of federal or state statute,[2] expenses for certain types of lobbying and political pressure activities,[3] payments to an influential party precinct captain, in order to obtain a state printing contract[4] and other similar disbursements.[5]

As illustrative, we find it helpful to apply the test to two simple situations. An ordinary grocer, who bribes a policeman to let him place his wares on a public sidewalk in front of his store in violation of a municipal ordinance, cannot deduct the amount of the

---

[1] *United States* v. *Sullivan*, 274 U. S. 259, 264.

[2] *Great Northern Ry. Co.* v. *Commissioner*, 40 F. 2d 372 and *Lentin* v. *Commissioner*, 226 F. 2d 69.

[3] *Textile Mills Sec. Corp.* v. *Commissioner*, 314 U. S. 326.

[4] *Rugel* v. *Commissioner*, 127 F. 2d 393.

[5] See *Heininger* v. *Commissioner*, 320 U. S. 467 (affirming this court, 133 F. 2d 567).

bribe as an ordinary and necessary expense of his grocery business. The payment is a concomitant, but not an integral part, of the grocery business. If a handbook operator takes over the store used by the grocer and bribes the same policeman to permit the placing of chairs for the bettors on the same sidewalk in violation of the same ordinance, that payment would for the same reason be nondeductible. The payment is a concomitant, but not an integral part, of the handbook business. Both the grocer and the handbook operator, during their respective occupancies of the store, would be entitled to deduct on their income tax returns expenditures for salaries of clerks, rent of the store and other ordinary and necessary expenses of their businesses, because such payments are an integral part of the business.

To the extent that such ordinary and necessary expenses exist, a holding that they are undeductible by a handbook operator in a state in which the business is unlawful, would mean that such a tax would be levied by the federal government on gross income, while a holding that they are deductible in a state in which the business is lawful, would mean that such a tax would be levied on only net income. We cannot believe that the congress intended this inequitable result. Certainly the clear language of the act does not suggest that such consequences were contemplated by the congress.

Other examples illustrate the fallacy of the Commissioner's contention. Thus one state may prohibit the business of selling automobiles on Sunday, while another may not. Would the Commissioner argue that a dealer who did business on Sunday in the first state could not deduct from his gross receipts salaries and rent paid for his unlawful activity on that day, while a dealer in the second state could make such deduc-

tions? In some areas the sale of intoxicating liquor at retail is legal, and in others it is illegal. Would a retailer's salary and rent payments be deductible or not depending entirely on the lawfulness of his business?

Cases might arise in which the charge of unlawfulness might be denied. In the absence of a criminal trial to resolve the question of the taxpayer's guilt, is that question to be tried by the Commissioner and the Tax Court in tax proceedings? Such a situation might arise from the Commissioner's argument, based on the Illinois statute's provision that an owner, who knowingly permits his property to be used for gambling, shall be subject to punishment, and the further provision that an accessory to the perpetration of a crime shall be punished as a principal. He argues that respondent, in paying rent for his leased handbook premises, is an accessory to the crime of the landlord. If this theory is tenable, someone must determine whether the landlord *knowingly* permitted the illegal use of his premises. Is this question to be determined in a proceeding to which the landlord is not a party? If so, who is to make that determination,—the Commissioner and the Tax Court? These questions are suggestive of the many surprising results which would follow the adoption of the Commissioner's theories. We cannot believe that they were intended by the congress. The clear language of sec. 23 is a bar to such excursions as the Commissioner's contentions would invite.

The Commissioner should have allowed salaries and rent as deductions under sec. 23 (a). Hence the Tax Court's decision is correct and is affirmed.

We feel that it is important to call the attention of the Commissioner to the fact that in this and other cases before us his counsel repeatedly ignore rule 16

(c), (d) and (e), of this court regulating the contents of briefs.

Affirmed.

FINNEGAN, *Circuit Judge*. Dissenting. Book-making is a statutory criminal offense in Illinois. (Ill. Rev. Stat. 1955, chap. 38, par. 336). It is undisputed that appellee Charles V. Doyle operated " a bookmaking establishment" in that State for the tax years involved. Shortly stated the question is, can Doyle's disbursements for salaries and rents incurred in his illegal enterprise be classed "ordinary and necessary" under § 23 (a) (1), Internal Revenue Code of 1939. Under the Illinois statute Doyle's expense items are unnecessary, though perhaps ordinary. But for deductibility as business expenses in computing federal income taxes, the Congressional mandate requires both elements—ordinary and necessary. I am unable to ignore the public policy of Illinois manifested by its statute proscribing the behavior generating Doyle's items of rent and salaries. The "temerity to raise" such deductibility was long ago anticipated in another case. *United States* v. *Sullivan*, 274 U. S. 259, 264 (1927). I would reverse the Tax Court decision and remand this case with directions to disallow the deductions claimed.

U. S. GOVERNMENT PRINTING OFFICE 1957

Office - Supreme Court, U.S.
FILED
SEP 23 1957
JOHN T. FEY, Clerk

No. 119

In the Supreme Court of the United States

OCTOBER TERM, 1957

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

NEIL SULLIVAN AND GRACE SULLIVAN; JAMES ROSS AND ANN ROSS; SAM MESI

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE PETITIONER

J. LEE RANKIN,
Solicitor General,
CHARLES K. RICE,
Assistant Attorney General,
JOSEPH F. GOETTEN,
MEYER ROTHWACKS,
Attorneys,
Department of Justice, Washington 25, D. C.

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes involved	2
Statement	4
Summary of argument	7
Argument	11
I. The payments which taxpayers seek to deduct were independently illegal under Illinois law and were made to induce others to commit crimes. Accordingly, they do not qualify for deduction as "ordinary and necessary" business expenses under Section 23 (a) (1) (A)	11
1. In general; the "public policy" rule	14
2. Specifically, the expenditures here are not deductible because they were independently illegal under Illinois law and were made to induce others to commit crimes	26
II. The taxpayers' arguments in support of deductibility are without merit	30
1. The fact that "rentals" and "salaries" are mentioned in Section 23 (a) does not excuse such expenses from the requirement that they must also be "ordinary and necessary"	30
2. The failure of Congress to impose a gross income tax on illegal wagering in 1951 sheds no light on the deductibility under the 1939 Code of payments which are independently illegal	32
3. To disallow these deductions would not result in imposing a "discriminatory" gross income tax on gamblers	34
4. The "integrality" test is unsupportable under the statute	35
Conclusion	38
Appendix	39

CITATIONS

Cases:

	Page
Achelis v. *Commissioner*, 28 B. T. A. 244	19–20
American Brewery v. *United States*, 223 F. 2d 43	20
American Hardware & Eq. Co. v. *Commissioner*, 202 F. 2d 126	24
Anderson v. *Commissioner*, 35 B. T. A. 10	15
Atlantic Terra Cotta Co. v. *Commissioner*, 13 B. T. A. 1289	22
Backer v. *Commissioner*, 1 B. T. A. 214	15–22
Binder v. *Commissioner*, decided May 27, 1953 (T. C.)	22
Bonnie Bros., Inc. v. *Commissioner*, 15 B. T. A. 1231	19
Boyle, Flagg & Seaman, Inc. v. *Commissioner*, 25 T. C. 43	20
Burroughs Bldg. Material Co. v. *Commissioner*, 47 F. 2d 178	20–21
Camarano v. *United States*, decided July 8, 1957 (C. A. 9th)	25
Clark v. *Commissioner*, 19 T. C. 48	23
Clarke v. *Haberle Brewing Co.*, 280 U. S. 384	15
Colgrove v. *Lowe*, 343 Ill. 360	39
Comeaux v. *Commissioner*, 10 T. C. 201, affirmed, *sub nom. Cohen* v. *Commissioner*, 176 F. 2d 394	28–36
Commissioner v. *Doyle*, 231 F. 2d 635	5, 6, 12, 35, 36, 37, 39
Commissioner v. *Heininger*, 320 U. S. 467	8, 12, 16, 18, 19, 21, 26, 28, 31
Commissioner v. *Longhorn Portland Cem. Co.*, 148 F. 2d 276, certiorari denied, 326 U. S. 728	20, 22
Commissioner v. *Munter*, 331 U. S. 210	26
Commissioner v. *Pacific Mills*, 207 F. 2d 177	20
Commissioner v. *Schwartz*, 232 F. 2d 94	22
Corn Products Co. v. *Commissioner*, 350 U. S. 46	26
Darenshire, Inc. v. *Commissioner*, 12 T. C. 958	20
Davis v. *Commissioner*, 17 T. C. 549	23
Dempsey v. *Commissioner*, decided September 28, 1951 (T. C.)	23
Deputy v. *duPont*, 308 U. S. 488	14, 15
Doyle v. *Commissioner*, decided December 27, 1954 (T. C.)	35
Easton Tractor & Equipment Co. v. *Commissioner*, 35 B. T. A. 189	24, 36
Ellery v. *Commissioner*, 4 T. C. 407	15
English v. *Commissioner*, decided November 16, 1956 (T. C.)	29

Cases—Continued

	Page
Fazzio v. Commissioner, decided September 7, 1943 (T. C.)	24
Finley v. Commissioner, 27 T. C. 413	24
Fuller v. Commissioner, 293 F. 2d 102	25, 26
Garibaldi & Cuneo v. Commissioner, 9 T. C. 446	21
Gilmore v. United States, 131 F. Supp. 581	23
Gibbini v. Commissioner, decided October 27, 1939 (B. T. A.)	24, 37
Great Northern Ry. Co. v. Commissioner, 40 F. 2d 372, certiorari denied, 282 U. S. 855	15, 20, 37
Harden M. Lotz Co. v. Commissioner, 137 F. 2d 282	24, 36
Helvering v. Superior Wines & Liquors, 134 F. 2d 373	20
Helvering v. Wiangill, 305 U. S. 79	26
Hoover Motor Express Co., Inc. v. United States, 241 F. 2d 459, pending on writ of certiorari, No. 95, this Term	21
Humphreys v. Commissioner, 125 F. 2d 340, certiorari denied, 317 U. S. 637	28, 36
Joseph v. Commissioner, 26 T. C. 562	22
Kansas City Southern Ry. Co. v. Commissioner, 22 B. T. A. 949	19
Kaiser, Estate of v. Commissioner, decided July 13, 1954 (T. C.)	24, 37
Kelley-Dempsey & Co. v. Commissioner, 31 B. T. A. 351	23, 37
Lehman v. Commissioner, 25 T. C. 629	23
Leslie v. Commissioner, 226 F. 2d 605, certiorari denied, 350 U. S. 934	24, 36
Leichsteln v. Commissioner, 19 B. T. A. 99	21
Lilly v. Commissioner, 343 U. S. 90	8, 13, 18, 26, 30, 37
Lindheim v. Commissioner, 2 B. T. A. 229	22
Lorentz Corp. v. Commissioner, 33 B. T. A. 1158	23
McCulloch-Trumbey Co. v. Commissioner, 19 T. C. 297, reversed, 217 F. 2d 320	24
MacComber, Estate of v. Commissioner, decided August 26, 1955 (T. C.), vacated and remanded, 240 F. 2d 844	22
McGrath v. Commissioner, 27 T. C. 117	29
Maddox v. Commissioner, 40 B. T. A. 572, affirmed, 114 F. 2d 348	22
Mushy Hotel Co. v. Commissioner, decided October 22, 1954 (T. C.)	25

Cases—Continued

	Page
National Brass Works v. *Commissioner*, 182 F. 2d 526	15, 18, 20
National Enforcement Commission v. *Slim Olson, Inc.*, 224 F. 2d 92	22
New Colonial Co. v. *Helvering*, 292 U. S. 435	14
Newman v. *Commissioner*, decided August 29, 1952 (T. C.)	23
New Orleans Motor Co. v. *Commissioner*, decided June 30, 1949 (T. C.)	21
New Orleans Tractor Co. v. *Commissioner*, 35 B. T. A. 218	15
Nicholson v. *Commissioner*, 38 B. T. A. 190	24, 36
Pedone v. *United States*, 151 F. Supp. 288	22, 23
Reliable Milk & Cream Co. v. *Commissioner*, decided August 20, 1938 (B. T. A.)	23, 36
Renziehausen v. *Lucas*, 280 U. S. 387	15
Revere Racing Assn. v. *Scanlon*, 137 F. Supp. 293	25
Roberts Dairy Co. v. *Commissioner*, 195 F. 2d 948, certiorari denied, 344 U. S. 865	24
Rossman Jersey Corp. v. *Commissioner*, 175 F. 2d 711	20
Rugel v. *Commissioner*, 127 F. 2d 393	24, 36
Sanitary Earthenware Specialty Co. v. *Commissioner*, 19 B. T. A. 641	22
Scioto Provision Co. v. *Commissioner*, 9 T. C. 439	21
Silberman v. *Commissioner*, 44 B. T. A. 600	15, 28
Solon Decorating Co. v. *Commissioner*, decided February 28, 1957 (T. C.)	22
Standard Oil Co. v. *Commissioner*, 129 F. 2d 363, certiorari denied, 317 U. S. 688	20, 36
Stella v. *Commissioner*, 9 T. C. 801	22, 35
Sunset Scavenger Co. v. *Commissioner*, 84 F. 2d 158	24
Tank Truck Rentals, Inc. v. *Commissioner*, 242 F. 2d 14, pending on writ of certiorari No. 109, this term	21
Terminal Railroad Assn. of St. Louis v. *Commissioner*, 17 B. T. A. 1135, affirmed, *sub nom. Terminal R. R.* v. *Commissioner*, 61 F. 2d 166, certiorari denied, 288 U. S. 601	16, 20, 37
Tex-O-Kan Flour Co. v. *Commissioner*, 38 B. T. A. [illegible]	37
[illegible] Oil Co. v. *Commissioner*, 314 U. S. 326	8, 12, 16, 17, 24, 25
Thomas v. *Commissioner*, 86 T. C. 1417	22

Cases—Continued

	Page
Thompson, Estate of v. *Commissioner*, 21 B. T. A. 568; appeal dismissed, 62 F. 2d 1082	21
Turnipseed v. *Commissioner*, 27 T. C. 758	25
Union Packing Co. v. *Commissioner*, decided November 22, 1955 (T. C.)	22
United States v. *Algoma Ky[illegible]* [illegible] F. 2d 115, certiorari denied, 350 U. S. 960	25
United States v. *Joffray*, 97 F. 2d 448; affirmed, *sub nom. United States* v. *Bertelsen & Petersen Co.*, 306 U. S. 276	20
United States v. *Olympic Radio and Television*, 349 U. S. 232	14
United States v. *Sullivan*, 274 U. S. 259	12, 23
Universal Atlas Cement Co. v. *Commissioner*, 9 T. C. 973, affirmed, *per curiam*, 171 F. 2d 294, certiorari denied, 336 U. S. 962	20, 21
Welch v. *Gill*, 32 Wis. 159	28
Watterson, Henry, Hotel Co. v. *Commissioner*, 15 T. C. 902, affirmed, *per curiam*, 194 F. 2d 589	21
Weather-Seal Mfg. Co. v. *Commissioner*, 16 T. C. 1342, affirmed, *per curiam*, 199 F. 2d 376	22
Welch v. *Helvering*, 290 U. S. 111	15, 25, 30
White v. *United States*, 305 U. S. 281	14
Wolf Manufacturing Co. v. *Commissioner*, 10 B. T. A. 1161	22
Woolworth, F. W., Co. v. *Kavanagh*, 102 F. Supp. 9, affirmed, *per curiam*, 202 F. 2d 154	22
Zahnzie v. *Commissioner*, 27 T. C. 870	22

Statutes:

Defense Production Act of 1950, 64 Stat. 798:	
[illegible]	22
Internal Revenue Code of 1939:	
Sec. 23 (a), 26 U. S. C. 23 (a)	2
[illegible] 9, 10, 11, 12, 14, 16, 25, 27, 30, 31, 32, 37	
Sec. 23 (e) (26 U. S. C. 23 (e))	26
Sec. 24 (b), 26 U. S. C. 24 (b)	26
Internal Revenue Code of 1954:	
Sec. 151 (a) (26 U. S. C., Supp. IV, 151 (a))	25
Sec. 152 (a) (26 U. S. C., Supp. IV, 152 (a))	25
Sec. 162 (a) (26 U. S. C., Supp. IV, 162 (a))	14
Securities Exchange Act of 1934, c. 404, 48 Stat. 881, Sec. 16 (b)	23
Stabilization Act of 1942, 56 Stat. 765	23

Statutes—Continued

Page

Illinois Revised Statutes (1945), c. 38 (Criminal Code):

sec. 139 29

sec. 140 29

sec. 356 3, 5, 9, 11, 26, 29

sec. 582 4, 5, 29

Miscellaneous:

27 A. L. R. 2d 503, Note 18

Baker, *The Federal Taxing Power and Organized Crime*, 2 Wash. U. L. Q. 121 (1953) 27, 28

Brookes, *Litigation Expenses and the Income Tax*, 12 Tax L. Rev. 241 (March, 1957) 18

97 Cong. Record, Part 9, pp. 12230–12244 33

Lurie, *Deductibility of "Illegal" Expenses*, Eleventh Annual N. Y. U. Institute on Federal Taxation (1952), p. 1189 18

4 Mertens, *Law of Federal Income Taxation* (Rev.), Secs. 25.131–25.135 18, 19

Paul, *The Use of Public Policy by the Commissioner in Disallowing Deductions*, 8th Cal. Tax Institute (1954), p. 715 18

Rep. No. 781, 82d Cong., 1st Sess., p. 120 (1951-2, Cum. Bull. 458, 534) 28, 33

Schwartz, *Business Expenses Contrary to Public Policy: An Evaluation of the Lilly Case*, 8 Tax L. Rev. 241 (January, 1953) 18, 19

Treasury Regulations 74, Article 262 27

Treasury Regulations 103,

sec. 29.23(a)-1 27

sec. 29.23(q)-1 25

Treasury Regulations 111,

sec. 29.23(a)-1 25

sec. 29.23(q)-1 25

Treasury Reg. 86, sec. 19.23(a)-1 25

sec. 19.23(q)-1 25

In the Supreme Court of the United States

OCTOBER TERM, 1957

No. 119

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

NEIL SULLIVAN AND GRACE SULLIVAN; JAMES ROSS AND ANN ROSS; SAM MESI

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court in the *Sullivan* and *Ross* cases (R. 5–16) are not officially reported; the opinion of the Court of Appeals (R. 20–22) is reported at 241 F. 2d 46. The Tax Court's findings of fact and opinion in the *Mesi* case (R. 81–95) are reported at 25 T. C. 513; the opinion of the Court of Appeals (R. 98–100) is reported at 242 F. 2d 558.

JURISDICTION

The judgments of the Court of Appeals in the *Sullivan* and *Ross* cases (R. 22–23) were entered on February 13, 1957. The judgment of the Court of

Appeals in the *Mesi* case (R. 100-101) was entered on April 5, 1957. The petition for a writ of certiorari, filed on May 9, 1957, was granted on June 17, 1957. (R. 101.) The jurisdiction of this Court rests upon 28 U. S. C. 1254.

QUESTION PRESENTED

Whether amounts expended to lease premises and hire employees for the conduct of illegal gambling enterprises were deductible as ordinary and necessary business expenses within Section 23 (a) (1) (A) of the Internal Revenue Code of 1939, where the expenditures themselves constituted violations of the criminal statutes of the State of Illinois and were made for the purpose of inducing others to violate the law.

STATUTES INVOLVED

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [as amended by Sec. 121 (a), Revenue Act of 1942, c. 619, 56 Stat. 798, 819] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *, and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property

to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(26 U. S. C. 1952 ed., Sec. 23 (a).)

Illinois Revised Statutes (1945), c. 38 (Criminal Code):

GAMBLING AND GAMBLING DEVICES

336. *Book-making and pool-selling unlawful.* § 1. * * * That any person who keeps any room, shed, tenement, tent, booth, or building, or any part thereof, or who occupies any place upon any public or private grounds within this state, with any book, instrument or device for the purpose of recording or registering bets or wagers, or of selling pools, or any person who records or registers bets or wagers, or sells pools upon the result of any trial or contest of skill, speed or power of endurance of man or beast, or upon the result of any political nomination, appointment or election, or being the owner, lessee or occupant of any room, shed, tenement, tent, booth, or building, or part thereof, knowingly permits the same to be used or occupied for any of these purposes, or therein keeps, exhibits or employs any device or apparatus for the purpose of recording or registering such bets or wagers, or selling of such pools, or becomes the custodian or depository for hire or privilege, of any money, property, or thing of value staked, wagered or pledged upon any such result, shall be punishable by imprisonment in the county jail for a period not longer than one year or by fine not exceeding $2,000 or both. * * *

ACCESSORIES

582. *Before the fact.* § 2. An accessory is he who stands by, and aids, abets or assists, or who not being present, aiding, abetting or assisting, hath advised, encouraged, aided or abetted the perpetration of the crime. He who thus aids, abets, assists, advises or encourages, shall be considered as principal, and punished accordingly.

STATEMENT

Sullivan and Ross. During 1948, 1949 and 1950, the taxpayers, Neil Sullivan and James Ross,[1] were equal partners in a bookmaking establishment in Chicago, Illinois, which was engaged in accepting wagers on horse races. (R. 7–8.) The enterprise was illegal under the Criminal Code of Illinois. (R. 15, 21.)

The partnership claimed deductions for the following amounts of wages and rent paid during the years involved (R. 11):

Year	Wages	Rent
1948	$15,750	$8,735
1949	20,938	9,200
1950	24,050	9,215

The services for which the wages were paid to the six or seven employees of the partnership were performed in the operation of the bookmaking business, including the recording of bets. (R. 11.)

The activities of the partnership were conducted in various leased rooms in the upper floors of a hotel located in the central business district of Chicago.

[1] Grace Sullivan and Ann Ross are taxpayers because they filed joint returns with their husbands.

Because of frequent police raids, the partnership changed its rooms at the hotel from time to time. The lessor knowingly permitted the rooms to be used for bookmaking purposes. (R. 7, 9–11.)

The Tax Court found that the acts performed by the employees of the partnership in return for their wages, and by the lessor in return for the rents paid, constituted violations of Section 330 of the Criminal Code of the State of Illinois. It also found that the payment of the wages and rents by the taxpayer constituted a violation of Section 582 of that Code. (R. 11.)

The Tax Court held that to allow the amounts so paid to be deducted from gross income would constitute a clear violation of public policy, since it would permit the deduction of expenditures, the making of which constituted illegal acts. Accordingly, it held that the deductions should be disallowed. (R. 15–16.)

The Court of Appeals, on the authority of its prior holding in *Commissioner* v. *Doyle*, 231 F. 2d 635, reversed the judgment of the Tax Court.[1] It remanded the cause solely for the redetermination of an issue not before this Court. (R. 21–22.)

Mesi. During the year 1946, the taxpayer was engaged in accepting wagers on horse races, commonly known as bookmaking. He had a principal location from which he operated his gambling business, but compelled to move about because of raids by the police, he operated from three or four different lo-

---

[1] The decisions below in the instant cases followed the result of the *Doyle* case, and, for the Court's convenience, the *Doyle* opinion is reproduced in the Appendix, *infra*, pp. 22a–24a.

cations during 1946, including a garage, basements, hallways and alleyways. His activities were extensive. Although the great majority of the bets taken were small—for 50 cents, $1, or $2—and no bets in excess of $100 were accepted, incoming bets totaled $793,287.50 in 1946. (R. 82–83.)

The taxpayer spent little time at his establishment during the daytime, occasionally visited it in the afternoons, and usually went there in the evenings when the summaries of the day's activities were being prepared. During 1946, he employed six or seven persons, including a cashier, two or three sheet writers who accepted and entered the incoming bets, men on the "hard cards,"[3] and a doorman. He paid these employees gross wages, aggregating $14,563.84, which the Commissioner disallowed as a deduction. (R. 83, 90.)

The Tax Court found that the services which the employees had performed constituted a violation of Section 336 of the Criminal Code of the State of Illinois, and that the payment of the wages, in and of itself, constituted an illegal act. Accordingly, it held that the deduction for the wages paid had been properly disallowed for the reason that "it would be a clear violation of public policy to permit the deduction of an expenditure, the making of which constitutes an illegal act." (R. 86, 93.)

The Court of Appeals, relying upon its prior decisions in the *Doyle* case (Appendix, *infra*, pp. 39–46)

[3] The "hard cards" were large cardboard sheets, one for each track, which showed the entries for the day, the jockey, and the probable odds. (R. 83.)

and in the *Sullivan* and *Ross* cases (R. 20–22), reversed the judgment of the Tax Court and remanded the case for further proceedings with respect to an issue not raised here (R. 100–101).

SUMMARY OF ARGUMENT

I

The amounts which the taxpayers seek to deduct as "ordinary and necessary" business expenses were payments that were illegal under Illinois law, independent of the fact that they were engaged in an illegal business. The Illinois statute makes it a crime for an owner of a building knowingly to allow someone to use the premises for a bookmaking establishment. The expenditures which the taxpayers seek to deduct as "rent" were payments made to a hotel to induce the hotelkeeper to commit that crime.

Similarly, the "wages" paid to those who worked at the bookmaking establishment were illegal, not because the taxpayers were engaged in an illegal enterprise but because the payments were themselves made to bring about the commission of additional crimes. The Illinois statute makes it a crime to record or register bets as well as to aid and abet the running of a gambling establishment. The payments to their associates which the taxpayers seek to deduct were the very payments used to induce those persons to commit crimes. The payments here in question are thus unlike other expenditures of a bookmaking enterprise, such as for paper and pencils, gasoline for the cars, etc., which it may not be a crime to make and which do not induce other persons to commit a crime.

There is a general rule accepted by this Court and applied in a great many cases that what constitutes an "ordinary and necessary" business expense must be determined in the light of state and federal legislation which may make certain conduct or expenditures illegal. Frequently referred to as a "public policy" limitation, the principle is really one of statutory construction. This Court has held that business expenses "arising from that family of contracts to which the law has given no sanction" need not be considered as "ordinary and necessary." *Textile Mills Corp.* v. *Commissioner*, 314 U. S. 326, 339. In *Commissioner* v. *Heininger*, 320 U. S. 467, 473–474, and in *Lilly* v. *Commissioner*, 343 U. S. 90, 96–97, the Court indicated a rule of nondeductibility in those situations in which the allowance of a deduction "would frustrate the sharply defined policies" by which the federal or state government proscribed "particular types of conduct."

This rule has been applied in a large number of cases. Payments for lobbying activities were disallowed in the *Textile Mills* case. Bribes have regularly been disallowed on the theory that they are illegal and that no matter how "ordinary" they are they cannot be held to be "necessary." Similarly, where the expense was incurred as legal fees in defense of criminal conduct it has been found not "ordinary and necessary" and hence nondeductible. Where wages [illegible] in excess of those legally allowed, [illegible] which it was illegal to make [illegible] nondeductible. Fines imposed for [illegible] have regularly been held not to be

deductible. In such cases the expenses are not "ordinary and necessary," for to allow deduction would frustrate public policy embodied in provisions of law.

II

The taxpayers' arguments in support of deductibility are without merit.

1. The taxpayers point to the fact that rentals and salaries are specifically mentioned in Section 23 (a) (1) (A) as being included within the class of ordinary and necessary business expenses. But salaries and rentals, like every other category of business expense, are deductible only if they are "ordinary and necessary." A business cannot deduct compensation paid for personal services unless those services are an ordinary and necessary part of the business. But bribes, the classic example of nondeductible expense, are payments for services. Payments made to lawyers in defense of criminal charges and wages in excess of statutory ceilings are other examples of personal compensation to which the public policy rule has properly been applied. The fact that personal compensation and rentals are specifically listed in Section 23 (a) (1) (A) does not make them immune from the test of "ordinary and necessary", which implicitly excludes "unlawful".

2. The taxpayers argue that Congress has manifested an intent that illegal enterprises should be allowed to deduct all of their expenses. The "legislative history" relied upon is the defeat of a proposal [illegible] Senator Byrd's amendment in 1951 under which "any expenses incurred in illegal wagering" would have

been disallowed as a deduction. But this argument is not persuasive. Congressional inaction in 1951 does not prove Congressional intent in 1939. Further, the 1951 proposal did not deal with the issue whether payments which are illegal in themselves were ordinary and necessary; the proposal was rather that *all* expenses incurred in one particular line of illegal activity, namely, illegal wagering, be made nondeductible. Finally, the proposal was only one of a package including a number of other measures directed at wagering houses, such as the filing of net worth statements, keeping of records, etc. The failure of Congress to accept this proposal does not reflect any purpose that all so-called business expenses which are themselves illegal are to be treated differently when made by persons engaged in an illegal enterprise than when made by persons engaged in a lawful business.

3. Disallowance of the deductions here involved does not mean, as the taxpayers contend, that they are being taxed on their gross income. The payments for rent and wages, in the circumstances of these cases, constituted crimes under the Illinois laws; for that reason, the expenditures could not qualify as "ordinary and necessary" within the meaning of Section 23 (a) (1) (A). The taxpayers would be entitled to deductions for any other expenses which could so qualify.

4. The court below held that expenditures are deductible, no matter how illegal they may be, if they are "economically * * * an integral part of a business." This criterion of deductibility finds no support in the statute. In addition to being too vague

and confusing for practical application, it is irreconcilable with the body of decisions construing Section 23 to preclude deduction of expenses which frustrate defined public policy. Expenditures made to induce commission of crimes, and which are *per se* illegal under state law, clearly fall within that category.

ARGUMENT

I. THE PAYMENTS WHICH TAXPAYERS SEEK TO DEDUCT WERE INDEPENDENTLY ILLEGAL UNDER ILLINOIS LAW AND WERE MADE TO INDUCE OTHERS TO COMMIT CRIMES. ACCORDINGLY, THEY DO NOT QUALIFY FOR DEDUCTION AS "ORDINARY AND NECESSARY" BUSINESS EXPENSES UNDER SECTION 23 (a) (1) (A).

The taxpayers in these three consolidated cases were engaged in bookmaking, an illegal enterprise in the State of Illinois. (R. 7, 15, 82–83; Section 336, Illinois Criminal Code, *supra*, p. 3.) During the years in question the taxpayers in the *Sullivan* and *Ross* cases took deductions for rents paid to lessors who knew that the premises were to be used for the proscribed criminal activity (R. 11), and the taxpayers in the *Sullivan*, *Ross* and *Mesi* cases took deductions for wages paid to their respective employees for services performed in the illegal operation of the ventures, including the recording of bets (R. 11, 90). The Tax Court determined that the payments of rents and wages were, in and of themselves, violations of the Illinois Criminal Code and of a clearly defined and declared public policy of that State. (R. 11, 15, 86, 93.) Accordingly, it held that the amounts paid were not deductible for income tax purposes. The Court of Appeals reversed. Ad-

verting to its rationale in *Commissioner* v. *Doyle* (Appendix, *infra*, pp. 39–46), it held, in effect, that despite their illegality the amounts paid were deductible as "integral" expenses of the business in which taxpayers were engaged.

The instant cases thus present the question whether such expenditures, the making of which was in violation of state law, are deductible from gross income as "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business" (Section 23 (a) (1) (A) of the Internal Revenue Code of 1939, *supra*, p. 2). The question, as well as its possible resolution, has not been unanticipated by this Court. In *United States* v. *Sullivan*, 274 U. S. 259, 264, the Court, in an opinion by Mr. Justice Holmes, replying to a suggestion that one engaged in the illicit traffic of liquor might be entitled to deduct illegal expenses such as bribery, stated: "This by no means follows, but it will be time enough to consider the question when a taxpayer has the temerity to raise it." In *Textile Mills Corp.* v. *Commissioner*, 314 U. S. 326, 339, this Court found that under the statutory standard of "ordinary and necessary" a line could be drawn "between legitimate business expenses and those arising from that family of contracts to which the law has given no sanction." In *Commissioner* v. *Heininger*, 320 U. S. 467, 473–474, this Court suggested a rule of nondeductibility in those situations in which the allowance of a deduction "would frustrate the sharply defined policies" by which the federal or state governments proscribed "particular types of conduct," a rule which was sub-

sequently reiterated in *Lilly* v. *Commissioner*, 343 U. S. 90, 97:

> The policies frustrated must be national or state policies evidenced by some governmental declaration of them.

In the *Lilly* case, hypothesizing the factual situation presented by the instant cases, this Court observed (pp. 94–95):

> We do not have before us the issue that would be presented by expenditures which themselves violated a federal or state law or were incidental to such violations. In such a case it could be argued that the outlawed expenditures, by virtue of their illegality, were not "ordinary and necessary" business expenses within the meaning of § 23 (a) (1) (A).

This is such a case, and the Government makes that argument now. We emphasize at the outset that this case does not involve a type of expenditure which would be any more deductible if it were made by a taxpayer engaged in a lawful rather than an unlawful business. Nor are we contending that Congress intended to tax the gross income of one business and the net income of another. Rather, the expenditures here—being illegal in themselves and, in fact, payments for the commission of crimes—would not be deductible by a taxpayer engaged in a legitimate business. They should, we submit, be treated no differently or more favorably merely because the taxpayers seeking to deduct them are engaged in an illegitimate business. We contend not that Congress

intended to levy a tax on the gross income of illegal businesses, but rather that, in providing that only "ordinary and necessary" expenses should be allowed as deductions in computing the taxable income of any business, Congress established a standard of deductibility which is not satisfied here, for in no sense can an expenditure to commit crime, illegal under applicable state law, be regarded as an "ordinary and necessary" expense of a business, whether the enterprise be legitimate or otherwise.

I. IN GENERAL: THE "PUBLIC POLICY" RULE

There is a well-established rule of construction of Section 23 (a) (1) (A) that it does not permit the deduction as "ordinary and necessary" of various expenditures where to do so would frustrate sharply defined public policies, as embodied in state and federal legislation.* Neither the judicial nor administrative practice has been uniformly consistent in the application of the principle, but its existence cannot be doubted.

The allowance of a deduction "depends upon legislative grace," and "only as there is clear provision therefor can any particular deduction be allowed." *New Colonial Co.* v. *Helvering*, 292 U. S. 435, 440; *White* v. *United States*, 305 U. S. 281, 292; *Deputy* v. *duPont*, 308 U. S. 488, 493; *United States* v. *Olympic Radio and Television*, 349 U. S. 232. Section 23 (a) (1) (A) does not authorize the deduction of every

* These cases arise under the Internal Revenue Code of 1939, and we refer throughout to Section 23 (a) (1) (A) of that Code. The issue is of continuing importance since Section 162 (a) of the 1954 Code contains similar language.

business expense incurred or paid during the taxable year. In order to be deductible, the expense must be "ordinary and necessary." The phrase is in the conjunctive, and both requirements must be satisfied. *Deputy* v. *duPont*, *supra*, 308 U. S. at 497; *Welch* v. *Helvering*, 290 U. S. 111, 113. Expenditures are not deductible simply because they were made in connection with an income-producing activity. *Welch* v. *Helvering*, *supra*; *Great Northern Ry. Co.* v. *Commissioner*, 40 F. 2d 372, 373 (C. A. 8th), certiorari denied, 282 U. S. 855; see also, *Clarke* v. *Haberle Brewing Co.*, 280 U. S. 384, 386–387, and *Ronziehausen* v. *Lucas*, 280 U. S. 387. "It would be an anachronism to say that * * * an act, so inimical to the public interest as to justify punishment for its commission, may at the same time be so recognized that the expense involved in its commission is sanctioned by the revenue law as an ordinary and necessary expense of carrying on a business." *Backer* v. *Commissioner*, 1 B. T. A. 214, 216. By this test, "it is not conceivable that Congress intended that section 23 (a), allowing deductions for business expenses, should be a medium for giving the benefits thereof directly or indirectly * * * where the expenditures are made to others in compensation to them for unlawful activities." *Silberman* v. *Commissioner*, 44 B. T. A. 600, 604 (deductions denied to New York bookmaker for the payments of rents and wages which were crimes under the New York statutes). Cf. *Ellery* v. *Commissioner*, 4 T. C. 407, 414. See also, *National Brass Works* v. *Commissioner*, 182 F. 2d 526, 530–531 (C. A. 9th); *New Orleans Tractor Co.* v. *Commissioner*, 35 B. T. A. 218, 226; *Anderson* v. *Com-*

missioner, 35 B. T. A. 10, 12; *Terminal Railroad Assn. of St. Louis* v. *Commissioner*, 17 B. T. A. 1435, affirmed, *sub nom. Tunnel R. R. v. Commissioner*, 61 F. 2d 166, 174 (C. A. 8th), certiorari denied, 288 U. S. 604, 607.

Although the language of Section 23 (a) (1) (A) "contains no express reference to the lawful or unlawful character of the business expenses which are declared to be deductible" (*Commissioner* v. *Heininger, supra*, 320 U. S. at 474), the words "ordinary and necessary" clearly carry such an implication. An expenditure, the making of which involves the commission of a crime, cannot be regarded as "ordinary and necessary" in any reasonable sense of those words. It was not necessary for Congress expressly to add the adjective "lawful", since it is plainly implied by, and comprehended within, the words "ordinary and necessary". Certainly Congress cannot be presumed to have regarded payments for the performance of a criminal act as other than extraordinary and unnecessary. In the *Textile Mills* case, *supra*, in upholding the validity of an interpretative regulation defining the words "ordinary and necessary" as excluding certain types of lobbying expenses, this Court said (pp. 338–339):

> The words "ordinary and necessary" are not so clear and unambiguous in their meaning and application as to leave no room for an interpretative regulation. The numerous cases which have come to this Court on that issue bear witness to that. *Welch* v. *Helvering*, 290 U. S. 111; *Deputy* v. *duPont*, 308 U. S. 488, and cases cited. Nor has the administrative agency

usurped the legislative function by carving out this special group of expenses and making them non-deductible. We fail to find any indication that such a course contravened any Congressional policy. Contracts to spread such invidious influences through legislative halls have long been condemned. *Trist* v. *Child*, 21 Wall. 441; *Hazelton* v. *Sheckells*, 202 U. S. 71. Whether the precise arrangement here in question would violate the rule of those cases is not material. The point is that the general policy indicated by those cases need not be disregarded by the rule-making authority in its segregation of non-deductible expenses. There is no reason why, in absence of clear Congressional action to the contrary, the rule-making authority cannot employ that general policy in drawing a line between legitimate business expenses and those arising from that family of contracts to which the law has given no sanction. The exclusion of the latter from "ordinary and necessary" expenses certainly does no violence to the statutory language. The general policy being clear it is not for us to say that the line was too strictly drawn.

The drawing of a line between permissible deductions and those expenditures which are not "ordinary and necessary" within the meaning of the statute is not the exclusive function of administrative interpretation. The lower courts have held—in many decisions applying the principles stated in the *Textile Mills* case, but not resting upon the language of any regulation—that, in circumstances where the expenditures violate declared public policy, they are not to be treated as "ordinary and necessary" in the

statutory context "as a matter of law" (*Lilly v. Commissioner, supra*, 343 U. S. at 97). "The Bureau of Internal Revenue, the Board of Tax Appeals, and the federal courts have from time to time, * * * narrowed the generally accepted meaning of the language used in § 23 (a) in order that tax deduction consequences might not frustrate sharply defined national or state policies proscribing particular types of conduct" (*Commissioner* v. *Heininger, supra*, 320 U. S. at 473); "in the nature of things public policy must narrow the field of allowable deductions which rest as they do upon legislative indulgence" (*National Brass Works* v. *Commissioner, supra*, 182 F. 2d, at 530).

The concept that the deductibility of business expenses is subject to an overriding public policy limitation has been applied by the lower courts in a variety of circumstances; indeed, so extensively as to cause this Court to comment that "A review of the situations which have been held to belong in this category would serve no useful purpose for each case should depend upon its peculiar circumstances." *Commissioner* v. *Heininger, supra*, 320 U. S. at 473.[*] Citing examples

[*] For a collection and analysis of many of the cases, see 4 Mertens, *Law of Federal Income Taxation* (Rev.), Sections 25.131-25.135; Paul, *The Use of Public Policy by the Commissioner in Disallowing Deductions*, So. Cal. Tax Institute (1951), p. 215; Lurie, *Deductibility of "Illegal" Expenses*, Eleventh Annual N. Y. U. Institute on Federal Taxation (1952), p. 1189; Schwartz, *Business Expenses Contrary to Public Policy: An Examination of the "Illegal Expense"*, 8 Tax L. Rev. 241 (January, 1953); Brookes, *Litigation Expenses and the Income Tax*, 12 Tax L. Rev. 241, 263-273 (March, 1957); 27 A. L. R. 2d 503, 536.

to illustrate the principle involved, this Court said (*Heininger, supra*, pp. 473–474):

> Where a taxpayer has violated a federal or a state statute and incurred a fine or penalty he has not been permitted a tax deduction for its payment. Similarly, one who has incurred expenses for certain types of lobbying and political pressure activities with a view to influencing federal legislation has been denied a deduction. And a taxpayer who has made payments to an influential party precinct captain in order to obtain a state printing contract has not been allowed to deduct their amount from gross income.

The illustrations were not intended to be, and are not, exhaustive. The cases in which the so-called public policy rule has been applied in denying deductions fall into several related and often overlapping groups.[6] One major group, comprising cases involving the payment of fines and penalties for violation of federal and state statutes, establishes that such payments, even though proximately connected with the taxpayer's business and, in some instances, even though inadvertent, unintentional or even unavoidable in the conduct of the taxpayer's business, are not deductible.[7] "The real reason for denying the deduct-

[6] See the categories suggested in 4 Mertens, *Law of Federal Income Taxation*, *supra*, Section 25.131, p. 276, and Schwartz, *Business Expenses Contrary to Public Policy: An Evaluation of the Lilly Case*, *supra*, p. 242.

[7] See, *e. g.*, *Bonnie Bros., Inc.* v. *Commissioner*, 15 B. T. A. 1231 (payment of fine for violation of federal laws regulating the interstate shipment of intoxicating liquors); *Kansas City Southern Ry. Co.* v. *Commissioner*, 22 B. T. A. 949 (payment of penalties for violation of federal statutes); *Achelis* v. *Com-*

bility of "penalties" is not that they are characterized as such but because allowance in many cases would be against public policy." *National Brass Works* v. *Commissioner*, *supra*, 182 F. 2d at 530. Manifestly, to the extent that allowance of a deduction constitutes a partial remission of fines or penalties by way of tax advantage, there is a frustration of the public policies against the proscribed activities, as embodied in the laws imposing the sanctions. Cf. *Jerry Rossman Corp.* v. *Commissioner*, 175 F. 2d 711 (C. A. 2d); *Commissioner* v. *Pacific Mills*, 207 F. 2d 177 (C. A. 1st); *National Brass Works* v. *Commissioner*, 182 F. 2d 526 (C. A. 9th); *American Brewery* v. *United States*, 223 F. 2d 43 (C. A. 4th).

---

missioner, 28 B. T. A. 244 (payment of a state penalty tax); *Dorchester, Inc.* v. *Commissioner*, 12 T. C. 958 (payment of "liquidated damages" for child labor violations); *Boyle, Flagg & Seaman, Inc.* v. *Commissioner*, 25 T. C. 43 (payments in violation of state insurance laws); *Great Northern Ry Co.* v. *Commissioner*, *supra*, and *Terminal Railroad Assn. of St. Louis* v. *Commissioner*, *supra* (penalties paid for violation of federal statutes pertaining to the operation of railroads); *Burroughs Bldg. Material Co.* v. *Commissioner*, 47 F. 2d 178 (C. A. 2d) (fines incurred as the result of the violation of state price-fixing laws); *United States* v. *Jeffray*, 97 F. 2d 188 (C. A. 8th), affirmed on other issues, *sub nom. United States* v. *Bethlehem & Petrosia Co.*, 306 U. S. 276 (penalty paid in civil action for negligent understatement of taxes); *Standard Oil Co.* v. *Commissioner*, 129 F. 2d 363 (C. A. 7th), certiorari denied, 317 U. S. 688 (damages paid to the Federal Government for illegal conversion of oil lands brought about by corruption (bribery)); *Helvering* v. *Superior Wines & Liquors*, 134 F. 2d 373 (C. A. 8th) (amounts paid in compromise of liabilities for violation of federal taxing statutes); *Commissioner* v. *Longhorn Portland Cem. Co.*, 148 F. 2d 276 (C. A. 5th) certiorari denied, 326 U. S. 728, and *Universal Atlas Cement Co.* v. *Commissioner*, 9 T. C. 971, affirmed, *per curiam*, 171 F. 2d 294 (C. A. 2d)

In *Commissioner* v. *Heininger, supra,* 320 U. S. at 473, footnote 8, this Court referred to a related group of cases in which the courts, for public policy reasons, have denied deductions as a matter of law: "A taxpayer who has been prosecuted under a federal or state statute and convicted of a crime has not been permitted a tax deduction for his attorney's fee." (citing *Estate of Thompson* v. *Commissioner*, 21 B. T. A. 568, appeal dismissed, 62 F. 2d 1082 (C. A. 8th), and *Burroughs Bldg. Material Co.* v. *Commissioner*, 47 F. 2d 178 (C. A. 2d)). This result was reached by "the clearest analogy" to the cases holding that fines and penalties paid for the commission of unlawful acts are not deductible as ordinary and necessary expenses. *Levinstein* v. *Commissioner*, 19 B. T. A. 99, 104–105. The courts have uniformly denied deductions for fees paid for the unsuccessful defense of criminal charges not only in cases where the taxpayers' enterprises were illegal, but also where

---

certiorari denied, 336 U. S. 962 (amounts paid in compromise of penalties for alleged violation of state anti-trust laws); *Lustig* v. *Commissioner*, 226 F. 2d 695 (C. A. 7th), certiorari denied, 350 U. S. 934; *Henry Watterson Hotel Co.* v. *Commissioner*, 15 T. C. 902, affirmed, *per curiam*, 194 F. 2d 539 (C. A. 6th); *Garibaldi & Cuneo* v. *Commissioner*, 9 T. C. 446; *Scioto Position Co.* v. *Commissioner*, 9 T. C. 439; and *New Orleans Motor Co.* v. *Commissioner*, decided June 30, 1949 (1949 P-H T. C. Memorandum Decisions, par. 49,173) (payments to the United States for overcharges made in violation of the Emergency Price Control Act of 1942); *Hoover Motor Express Co., Inc.* v. *United States*, 241 F. 2d 459 (C. A. 6th), pending on writ of certiorari in this Court, No. 95, this Term, and *Tank Truck Rentals, Inc.* v. *Commissioner*, 242 F. 2d 14 (C. A. 3d), pending on writ of certiorari in this Court, No. 109, this Term (penalties for violations of state weight limitation laws).

the businesses, though lawful, were unlawfully conducted.[5]

In still another group of cases, the courts have denied deductions, as a matter of law, for excessive wages paid in violation of certain federal legislation and regulations thereunder. In *Pedone* v. *United States*, 151 F. Supp. 288 (C. Cls.), *Solon Decorating Co.* v. *Commissioner*, decided February 28, 1957 (1957 P-H T. C. Memorandum Decisions, par. 57,035), and *Zelman* v. *Commissioner*, 27 T. C. 876 (the two latter cases pending on appeal in the Sixth Circuit), deductions were denied for wage payments in violation of the Defense Production Act of 1950; see also, *National Enforcement Commission* v. *Slim Olson, Inc.*, 221 F. 2d 92 (C. A. D. C.). In *Weather-Seal Mfg. Co.* v. *Commissioner*, 16 T. C. 1312, affirmed, *per curiam*, 192 F. 2d 376 (C. A. 6th); *N. A. Woodworth Co.* v. *Kavanaugh*, 102 F. Supp. 9 (E. D. Mich.), affirmed, *per curiam*, 202 F. 2d 154 (C. A. 6th); *Binder* v. *Commissioner*, decided May 27, 1953 (1953 P-H T. C. Memorandum Decisions, par. 53,183); and *Gilmore* v. *United*

[5] See, in addition to the other decisions cited above, *Backer* v. *Commissioner*, *supra*; *Lindheim* v. *Commissioner*, 2 B. T. A. 229; *Wolf Manufacturing Co.* v. *Commissioner*, 10 B. T. A. 1161; *Atlantic Terra Cotta Co.* v. *Commissioner*, 13 B. T. A. 1289; *Sanitary Earthenware Specialty Co.* v. *Commissioner*, 19 B. T. A. 641; *Estate of MacCrone* v. *Commissioner*, decided August 26, 1955 (1955 P-H T. C. Memorandum Decisions, par. 55,238), vacated and remanded, 240 F. 2d 841 (C. A. 3d); *Stralla* v. *Commissioner*, 9 T. C. 801; *Thomas* v. *Commissioner*, 16 T. C. 1417; *Joseph* v. *Commissioner*, 26 T. C. 562; *Union Packing Co.* v. *Commissioner*, decided November 22, 1955 (1955 P-H T. C. Memorandum Decisions, par. 55,308); *Commissioner* v. *Longhorn Portland Cem. Co.*, *supra*; *Commissioner* v. *Schwartz*, 232 F. 2d 94, 99 (C. A. 5th).

States, 131 F. Supp. 581 (N. D. Cal.), deductions were denied for wages paid in violation of the Stabilization Act of 1942. And in the *Pedone* case, *supra*, the Court of Claims, in sustaining the Government's denial of a deduction for "payments made in violation of law or public policy," said (p. 292):

> If it could not do so, it would find itself in the position of subsidizing the violation of its law or public policy, since a percentage of the improper payment, depending on the tax bracket of the taxpayer, would be recovered by him in the form of a reduction of his income tax.

For similar reasons, deductions have been denied for payments made by corporate officers or directors to their companies in reimbursement of profits realized under circumstances covered by Section 16 (b) of the Securities Exchange Act of 1934, c. 404, 48 Stat. 881. *Davis* v. *Commissioner*, 17 T. C. 549; *Dempsey* v. *Commissioner*, decided September 28, 1951 (1951 P-H T. C. Memorandum Decisions, par. 51,281); *Lehman* v. *Commissioner*, 25 T. C. 629.

Considerations of public policy have also resulted in denying deductions on account of bribes paid by bootleggers, and payments made in response to commercial extortion.[7] Deductions for "commissions" paid to

---

[7] See *Clark* v. *Commissioner*, 19 T. C. 48; *Lafayette Corp.* v. *Commissioner*, 33 B. T. A. 1158; *Newman* v. *Commissioner*, decided August 29, 1952 (1952 P-H T. C. Memorandum Decisions, par. 52,267); *Maddas* v. *Commissioner*, 40 B. T. A. 572, affirmed, 111 F. 2d 548 (C. A. 3d); *Kelley-Dempsey & Co.* v. *Commissioner*, 31 B. T. A. 351; *Reliable Milk & Cream Co.* v. *Commissioner*, decided August 20, 1938 (1938 P-H B. T. A. Memorandum Decisions, par. 38,290); cf. *United States* v. *Sullivan*, *supra*, 274 U. S. at 264.

persons for their use of personal influence in obtaining public contracts have been denied as against public policy (*Harden M. Loan Co.* v. *Commissioner*, 137 F. 2d 282 (C. A. 10th); *Rugel* v. *Commissioner*, 127 F. 2d 393 (C. A. 8th); *Easton Tractor & Equipment Co.* v. *Commissioner*, 35 B. T. A. 189; *Nicholson* v. *Commissioner*, 38 B. T. A. 190; *Finley* v. *Commissioner*, 27 T. C. 413); and so, too, have such a miscellany of expenditures as payments by abortionists to procurers and assistants (*Giubbini* v. *Commissioner*, decided October 27, 1939 (1939 P–H B. T. A. Memorandum Decisions, par. 39,471); *Estate of Karger* v. *Commissioner*, decided July 13, 1954 (1954 P–H T. C. Memorandum Decisions, par. 54,204); fees paid for membership identification tags on pinball machines where the purpose of the association was illegal (*Fazzio* v. *Commissioner*, decided September 7, 1943 (1943 P–H T. C. Memorandum Decisions, par. 43,410)); and payments for whiskey used for entertainment purposes by a legitimate business where it was unlawful under state law to purchase, give away, or furnish alcoholic beverages (*Finley* v. *Commissioner*, *supra*).

As already noted, this Court has refused to permit any deduction for lobbying expenditures incurred in order to procure legislation. *Textile Mills Corp.* v. *Commissioner*, *supra*.[10] Although the nondeductibil-

[10] See also, *Sunset Scavenger Co.* v. *Commissioner*, 84 F. 2d 453 (C. A. 9th); *American Hardware & Eq. Co.* v. *Commissioner*, 202 F. 2d 126 (C. A. 4th); *Roberts Dairy Co.* v. *Commissioner*, 195 F. 2d 948 (C. A. 8th), certiorari denied, 344 U. S. 865; *McClintock-Trunkey Co.* v. *Commissioner*, 19 T. C. 297, reversed on other grounds, 217 F. 2d 329 (C. A. 9th);

ity of lobbying and related expenditures has been covered by successive Treasury Regulations,[11] the regulation in *Textile Mills* did not constitute an exclusive application of the public policy considerations on which it rested. In the nature of things, such a regulation could be no more than illustrative; the Commissioner cannot attempt to promulgate Regulations to fit precisely every factual situation to which the tax laws apply. *Welch* v. *Helvering*, 290 U. S. 111, 115. The significance of *Textile Mills* is that it necessarily recognizes that considerations of public policy are properly taken into account in construing Section 23 (a) (1) (A)[12]—a conclusion strongly fortified by this

---

Mosby Hotel Co. v. *Commissioner*, decided October 22, 1954 (1954 P-H T. C. Memorandum Decisions, par. 54,288); *Revere Racing Assn.* v. *Scanlon*, 137 F. Supp. 293 (D. Mass); *Cammarano* v. *United States* (C. A. 9th), decided July 8, 1957 (57-2 U. S. T. C., par. 9825).

[11] Treasury Regulations 118, Sections 39.23(o)-1(f) and 39.23(q)-1(a); Treasury Regulations 111, Sections 29.23(o)-1 and 29.23(q)-1; Treasury Regulations 103, Sections 19.23 (o)-1 and 19.23 (q)-1. For prior administrative provisions, see *Textile Mills Corp.* v. *Commissioner*, *supra*, 314 U. S. at 337-338.

[12] Tax benefits, other than deductions for "ordinary and necessary" expenses under Section 23(a)(1)(A), have been denied on considerations of public policy. See, *e. g.*, *Turnipseed* v. *Commissioner*, 27 T. C. 758 (dependency exemption under Sections 151 (e)(1) and 152 (a)(9) of the Internal Revenue Code of 1954 denied for a member of the taxpayer's household with whom he lived in adultery, in violation of the laws of the State of Alabama); *United States* v. *Algemene Kunstzijde Unie, N. V.*, 226 F. 2d 115 (C. A. 4th), certiorari denied, 350 U. S. 969 (deduction under Section 23 (f) of the Internal Revenue Code of 1939 denied to a foreign corporation doing business in this country for loss incurred when certain of its assets were vested by the United States under the Trading with the Enemy Act); and *Fuller* v. *Commis-*

Court's subsequent observations in the *Heininger* and *Lilly* cases, *supra*. The many cases interpreting the statute as not authorizing deductions for illegal expenditures or those occasioned solely by the taxpayer's illegal conduct, clearly demonstrate the long-standing construction which the statute has been given. That construction is entitled to great weight, particularly in view of the successive reenactments of the statute employing the phrase "ordinary and necessary." Cf. *Corn Products Co.* v. *Commissioner*, 350 U. S. 46, 53; *Helvering* v. *Winmill*, 305 U. S. 79, 83; *Commissioner* v. *Hunter*, 331 U. S. 210, 214–215.

2. SPECIFICALLY, THE EXPENDITURES HERE ARE NOT DEDUCTIBLE BECAUSE THEY WERE INDEPENDENTLY ILLEGAL UNDER ILLINOIS LAW AND WERE MADE TO INDUCE OTHERS TO COMMIT CRIMES

The payments here are "rent" and "wages" paid in Illinois by bookmakers. The "rent" consisted of payments made by Sullivan and Ross to a downtown Chicago hotel for permission to use various rooms on its upper floors for the gambling operation. The "wages," paid by all of the taxpayers, were paid to other individuals for working in the bookmaking establishments. These payments were in themselves illegal, and hence not "ordinary and necessary".

Under Section 336 of the Illinois Criminal Code, *supra*, p. 3, any person "who records or registers bets or wagers" is guilty of a crime. Under the same section any person who "being the owner * * *

---

sioner, 213 F. 2d 102 (C. A. 10th) (deduction under Section 23 (e) of the Internal Revenue Code of 1939 denied for loss incurred when whiskey, being sold in a dry state, was confiscated by law enforcement officers).

of any room * * * or building * * * knowingly permits the same to be used" for gambling purposes is also guilty of a crime. It is this statute upon which we rely in contending that the payments here sought to be deducted are different from other payments which the taxpayers might make. The payments here in question are not illegal simply because the taxpayers are engaged in an illegal enterprise. When a bookmaker buys paper or pencils, or gasoline for his car, it is not necessarily an illegal transaction.

But the Illinois statute specifically makes it a crime to record wagers and knowingly to allow rooms to be used for bookmaking. Thus the payments which the tapayers seek to deduct are ones made to induce other persons to commit violations of state law. These payments are illegal not because the tapayers are engaged in illegal activities but because these payments were made for the purpose of bringing about additional crimes. There is no showing that the amounts paid were calculated as normal room rentals rather than at some higher rate to compensate for the criminal conduct being induced. And whatever the rate, it is clear that it was not a normal rental transaction. The owner was not being paid just to rent a room; he was being paid to commit a crime.

It may be that there are expenses which in themselves are lawful and are "ordinary and necessary" to the bookmaking activities of the taxpayers, and hence are properly deductible against their income.[13]

[13] There is a question whether Congress intended the words "trade or business" as used in Section 23 (a) (1) (A) to refer to illegal enterprises. See Baker, *The Federal Taxing Power and*

But the expenses here could not so qualify. It is not "necessary" to induce others to join them in their criminal undertaking. Paying someone else to commit a crime is a crime. Payments of the kind here involved, made to other persons for the purpose of inducing them to commit crimes, are illegal under Illinois law, independent of the fact that the persons making the payments were engaged in an illegal activity.

This is clear from the Tax Court's findings. In the *Sullivan* and *Ross* cases the Tax Court found that the (R. 11) "services of the employees for * * * wages were performed in the illegal operation" of the enterprise, and the same conclusion is implicit in its detailed findings in the *Mesi* case (R. 83–85). In the

---

Organized Crime, Wash. U. L. Q. 121, 140–146 (1953); *Humphreys* v. *Commissioner*, 125 F. 2d 340, 343 (C. A. 7th), certiorari denied, 317 U. S. 637; *Walsch* v. *Call*, 32 Wis. 159. Cf. S. Rep. No. 781, 82d Cong., 1st Sess., p. 120 (1951–2 Cum. Bull. 458, 544), where a proposal for legislation specifically disallowing any expenses incurred in illegal wagering and any losses resulting from illegal wagering was considered as requiring "additional time * * * for detailed study." But resolution of the question is not necessary here. It may be assumed, *arguendo*, that some expenditures of an illegal enterprise are "legitimate" expenses and, therefore, deductible (*Comeaux* v. *Commissioner*, 10 T. C. 201, 207, affirmed, *sub nom. Cohen* v. *Commissioner*, 176 F. 2d 394, 400 (C. A. 10th); *Silberman* v. *Commissioner*, 44 B. T. A. 600, 603–604)—and perhaps that is what this court implied in stating (*Commissioner* v. *Heininger*, 320 U. S. at 474) that it has "never been thought * * * that the mere fact that an expenditure bears a *remote* relation to an illegal act makes it non-deductible." (Emphasis supplied.) However, the payments of rents and wages in the instant cases obviously bear no mere remote relation to illegal acts; on the contrary, they were found to be, in themselves, illegal acts under the Illinois statutes and so clearly fall outside the category suggested in the *Heininger* case.

Sullivan and *Ross* cases the Tax Court also found that the (R. 11) "lessor knowingly permitted these rooms to be used for the purposes of bookmaking." There was thus full warrant for its findings in all of the cases that the acts performed by the employees in return for the wages, and by the lessor in return for the rents, "constituted violations of section 336 of the Criminal Code of the State of Illinois." (R. 11, 86.)

Section 582 of the Illinois Criminal Code, which must be read in connection with Section 336, provides, among other things, that one who "aids, abets, assists, advises or encourages" the perpetration of a crime "shall be considered as principal, and punished accordingly." The payment of wages to induce the employees in all of the cases below to commit the crime of registering wagers on horse races, and the payment of rents to induce the lessor in the *Sullivan* and *Ross* cases to commit the crime of knowingly permitting the premises to be used for the condemned purposes, plainly constituted such encouragement and aid in the illegal activities of those persons as to make the taxpayers, by virtue of the payments, accessories to the crimes committed by the payees and, therefore, punishable as principals. The Tax Court in effect so found. (R. 15, 93.) [14] See also, *McGrath* v. *Commissioner*, 27 T. C. 117, 131–132; and *English* v. *Commissioner*, decided November 16, 1956 (1956 P-H T. C.

[14] Moreover, in making the payments of rents and wages and thus inducing the payees to violate Section 336 of the Criminal Code of Illinois, the taxpayers also appear to have been conspirators, within the meaning of Sections 139 and 140 of the Illinois Revised Statutes (1945), c. 38 (Criminal Code).

Memorandum Decisions, par. 56,254). In making these payments, the taxpayers thus contravened state policies "evidenced by some governmental declaration of them" (*Lilly* v. *Commissioner, supra*, 343 U. S. at 97), since the public policy of a state is of course declared in its statutes (*Colgrove* v. *Lowe*, 343 Ill. 360).

II. THE TAXPAYERS' ARGUMENTS IN SUPPORT OF DEDUCTIBILITY ARE WITHOUT MERIT

The taxpayers make several arguments as to why the general rule forbidding deduction of illegal expenditures should not be applied here. None, we submit, has any substance.

1. THE FACT THAT "RENTALS" AND "SALARIES" ARE MENTIONED IN SECTION 23(a) DOES NOT EXCUSE SUCH EXPENSES FROM THE REQUIREMENT THAT THEY MUST ALSO BE "ORDINARY AND NECESSARY"

Under Section 23 (a) (1) (A) there are allowed as deductions in computing net income—

> All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * * and rentals or other payments required to be made as a condition to the continued use or possession * * * of property * * *.

No expense may be deducted under Section 23 (a) (1) (A) unless it is ordinary and necessary. *Welch* v. *Helvering*, 290 U. S. 111. The fact that the statute indicates that such expenses include "a reasonable allowance for salaries or other compensation for personal services actually rendered" does not mean that

such expenses are *always* ordinary and necessary, as a matter of law and without regard to the facts of the particular case. Congress has not declared that all compensation for services rendered is automatically deductible. The expense must also be ordinary and necessary.

It is plain from the language of Section 23 (a) (1) (A) that the clauses dealing with compensation and with rentals were inserted as limitations on, not as exceptions from, the requirement that they be "ordinary and necessary." Compensation must not only be ordinary and necessary but is further limited by the requirement that it be a "reasonable" allowance and that it be paid for "services actually rendered." Rentals similarly are limited so that they must not only be ordinary and necessary but also must be for the continued use of property "for purposes of the trade or business," and the property must be one in which the taxpayer has neither equity nor title interest.

In any event, the cases clearly establish that the test of "ordinary and necessary" applies to compensation for personal services as well as other types of expenditures. In their brief in opposition the taxpayers recognize (p. 5) that "courts have permitted consideration of the 'public policy' issue" when considering deductions for "bribes" and for "defense of fraud charges." Illustrations of such instances are contained in the Court's opinion in the *Heininger* case, 320 U. S. at 473–474. The courts have uniformly denied deductions for personal compensation paid for the unsuccessful defense of criminal charges

not only in cases where the taxpayers' enterprises were illegal, but also where the businesses, though lawful, were unlawfully conducted.[7] They have also denied deductions for salaries paid in excess of wage ceilings established by federal legislation.[8] Thus, the fact that rents and personal compensation are mentioned in Section 23 (a) (1) (A) in no way relieves such payments from the requirement of "ordinary and necessary."

2. THE FAILURE OF CONGRESS TO IMPOSE A GROSS INCOME TAX ON ILLEGAL WAGERING IN 1951 SHEDS NO LIGHT ON THE DEDUCTIBILITY UNDER THE 1939 CODE OF PAYMENTS WHICH ARE INDEPENDENTLY ILLEGAL

The taxpayers' second argument is (Br. in Opp. 6-9) that Congress has manifested an intent that gamblers be allowed to deduct all of their expenditures under Section 23 (a). The argument has two underlying assumptions, both of which are invalid. The first is that because Congress taxed gains, profits and income derived from illegal activities, it necessarily intended to permit deduction of all expenses incurred in connection therewith. The short answer, however, is that by its very terms Section 23 (a) (1) (A) restricts deductions to those expenses which are "ordinary and necessary," and expenditures—such as those here involved—made to induce others to commit crimes under state law are not "ordinary and necessary."

The second assumption is that, in failing in 1951 to enact into law Senator Kefauver's proposal that

[7] See cases cited at pp. 21-22, *supra*.

[8] See cases cited at pp. 22-23, *supra*.

no deduction shall be allowed for any expense paid or incurred in carrying on illegal wagering. Congress manifested an intent to permit deduction of all expenses in connection with that activity. The conclusion is a *non sequitur*. The failure of Congress in 1951 to impose a gross income tax on illegal wagering does not manifest its intent, in enacting the 1939 Code, with respect to the deductibility of payments which in themselves are unlawful. Moreover, the Senate committee report on the Kefauver proposal stated only that "additional time is necessary for detailed study of these suggestions and therefore * * * action on them should not be taken at this time." S. Rep. No. 781, 82d Cong., 1st Sess., p. 120 (1951–2 Cum. Bull. 458, 514). As the debate on the proposal amply demonstrates (97 Cong. Record, Part 9, pp. 12230–12244), far more was involved in Senator Kefauver's proposed amendment than the disallowance of all expenses paid or incurred in connection with illegal wagering. The proposed amendment was part of a legislative package, containing, in addition to the provision against deduction of all expenditures, provisions also for the maintenance and inspection of the records of wagering houses, for the filing of net worth statements by all individuals with gross income over $10,000 earned from one or more unlawful businesses, and for the preservation of records for a period of seven years after the date of the transactions to which they related. The Senate's rejection of the Kefauver proposal was at best equivocal, and affords no support for the sweeping inferences drawn by the taxpayers.

3. TO DISALLOW THESE DEDUCTIONS WOULD NOT RESULT IN IMPOSING A "DISCRIMINATORY" GROSS INCOME TAX ON GAMBLERS

The taxpayers suggest (Br. in Opp. 9–12) that if they are not allowed to deduct the payments here involved, the income tax will, as to them, become a tax on gross income. They say that, since this business is illegal, "all its expenses are illegal * * * because they are incurred in the carrying on of an illegal business." (Br. in Opp. 12.) But we do not contend that the rule is different as to illegal businesses from what it is for others. If a legitimate business pays a person to commit a crime, such payment is not deductible. If an illegal business pays a person to commit a crime, that, too, is nondeductible. Thus, if taxpayers are right, an illegal enterprise would obtain favored tax treatment because it is illegal—a result hardly intended by Congress.

There is no basis in principle for any distinction between the instant case and the many decisions in which deductions have been denied for certain expenditures made in connection with other illegal activities, bribes paid to public officers, wages paid in violation of federal statutes, fines and penalties paid for violation of federal and state statutes, payments for lobbying and political pressure activities, and the like. Here the expenditures were made to induce others to commit offenses; the making of the expenditures constituted crimes under Illinois law. A gambler's net income is taxed on the same basis as any other person's. When a particular payment or expense is illegal, such payment is not deductible, whether made by a legitimate or illegitimate business. Certainly,

the statute should not be construed to confer a tax benefit on those engaged in an illicit enterprise as against those engaged in a lawful business. For it is certainly settled that the latter cannot deduct expenses for commission of crimes.

4. THE "INTEGRALITY" TEST IS UNSUPPORTABLE UNDER THE STATUTE

In attempting a rationalization for treating the payments here involved differently from other types of admittedly nondeductible illegal expenditures, the decisions below rest upon the Seventh Circuit's characterization of the rents and wages paid under similar circumstances in the *Doyle* case, *supra*, as "integral." The concept advanced is that expenditures are deductible, no matter how illegal they may be,[17] provided they are "economically * * * an integral part of a business" while those which are only "concomitants to the business" are not deductible. *Commissioner* v. *Doyle*, 231 F. 2d 635, 637. "In this [latter] class", the Seventh Circuit stated, "fall bribes paid to public officers, fines and penalties imposed for violations of federal or state statute, expenses for certain types of lobbying and political pressure activities, payments to an influential party precinct captain, in order to obtain a state printing contract and other similar disbursements." (*Id.* at 637.)

[17] The Tax Court in *Doyle* v. *Commissioner*, decided December 27, 1954 (1954 P-H T. C. Memorandum Decisions, par. 54,340), made no findings, as it did in the instant cases, that the payments of rents and wages were, in themselves, offenses under state law. On the contrary, it concluded that the taxpayer was entitled to deduct the amounts of rents and wages on the authority of *Stralla* v. *Commissioner*, *supra*, and

The distinction between "integral" and "concomitant" business expenses is difficult to grasp.[7] For example, if state contracts can be obtained only by bribes or by payments to influential politicians, a taxpayer might not obtain business except by making the payments. In such circumstances, the payments would seem to be an "integral" rather than "concomitant" part of the business activity. *E. g., Rugel* v. *Commissioner, supra; Harder M. Loan Co.* v. *Commissioner, supra; Nicholson* v. *Commissioner, supra; Easton Tractor & Equipment Co.* v. *Commissioner, supra.* Similarly, payments to racketeers (*Reliable Milk & Cream Co.* v. *Commissioner*), decided August 20, 1938 (1938 P-H B. T. A. Memorandum Decisions, par. 38,290), amounts paid as commer-

---

Corcoran v. *Commissioner, supra*, 10 T. C. at 207, in which it said it had "considered the question of whether the *legitimate* expenses of an illegitimate business constituted allowable deductions for income tax purposes and concluded that they did." (Emphasis supplied.) The opinion of the Court of Appeals in the *Doyle* case, Appendix, *infra*, pp. 39-46, while making a passing reference to the Commissioner's insistence upon including "the element of lawfulness of expenses of rent and salaries of a trade or business as a requirement for their deductibility," in substance rested on the proposition that "integral" expenses should not be denied, even though the business in which they were incurred was unlawful. Cf. the Seventh Circuit's statement in the *Sullivan* and *Ross* cases (R. 22): "Our opinion in the *Doyle* case neither expressly treated, nor by any possible inference can be construed as treating, the wages and rents paid by the taxpayer as 'legitimate' expenses."

[7] The distinction appears to have been ignored by the Seventh Circuit in its prior decisions in *Leidig* v. *Commissioner*, 223 F. 2d 695, certiorari denied, 350 U. S. 934; *Standard Oil Co.* v. *Commissioner, supra*; and *Humphreys* v. *Commissioner*, 125 F. 2d 349, certiorari denied, 317 U. S. 637.

cial extortion; *(Kelley-Dempsey & Co. v. Commissioner*, 31 B. T. A. 351), payments by abortionists to assistants and procurers (*Giubini v. Commissioner, supra; Estate of Karger v. Commissioner, supra*); and payments of fines and penalties, even for violations unavoidable in the conduct of business (*Great Northern Ry. Co. v. Commissioner, supra; Terminal Railroad Assn. of St. Louis v. Commissioner, supra*)—all of which the Seventh Circuit would presumably classify as "concomitant"—are probably realistically regarded as "integral" aspects of those businesses. In *Textile Mills, supra*, in which the compensation paid by a corporation to a publicist and two legal experts would be "concomitant" under the *Doyle* test, it was conceded that those expenses were (38 B. T. A. 623, 627) "in fact ordinary and necessary in performing the services required of it under its contract" to procure the enactment of certain legislation.[10]

Apart from being unrealistic and unworkable, the "integral" test is, in any event, irreconcilable with the [illegible] and the many decisions holding that the standard of "ordinary and necessary" precludes allowance of those expenditures which "frustrate sharply defined national or state policies proscribing particular types of conduct," if the policies are "evidenced by some governmental declaration of them." *Lilly v. Commissioner, supra*, 343 U. S. at 95-97. A payment made for commission of a crime, or to [illegible]

[10] "If this Court had in *Textile Mills* taken the same view of the 'ordinary and necessary' clause of Section 23 (a) as the Seventh Circuit, it would have held Article 262 of Treasury Regulations 74 to be in conflict with the statute and invalid.

ter how "integral" it is in the carrying out of the business in which a taxpayer is engaged, could not have been regarded by Congress as "ordinary and necessary". In our society, and in any civilized society, it is not "ordinary and necessary" to commit crimes—and if Congress had legislated in the income tax laws on a contrary assumption, there would surely have been some indication to that effect in the language and history of the legislation. There is none.

CONCLUSION

The judgments of the court below should be reversed.

Respectfully submitted.

J. LEE RANKIN,
Solicitor General.
CHARLES K. RICE,
Assistant Attorney General.
JOSEPH F. GOETTEN,
MEYER ROTHWACKS,
Attorneys.

SEPTEMBER 1957.

APPENDIX

In the United States Court of Appeals for the Seventh Circuit

No. 11572. October Term, 1955, January Session, 1956

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHARLES V. DOYLE AND CLARA DOYLE, RESPONDENTS

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

April 11, 1956

Before MAJOR, FINNEGAN and SCHNACKENBERG, *Circuit Judges*

SCHNACKENBERG, *Circuit Judge*.

This petition for review involves income taxes and penalties of $7,223.75 for 1948, 1949 and 1950, and questions the correctness of a decision of the Tax Court entered on January 26, 1955. The petition was filed by the Commissioner on April 25, 1955, pursuant to sec. 7482 of the Internal Revenue act of 1954.[1]

As expressed in the words of the Commissioner, the question presented is whether expenses for rent and wages incurred in the operation of an illegal gambling business are themselves contrary to a sharply defined and declared public policy of the state of Illinois and hence are not deductible for income tax purposes,

[1] 26 U. S. C. A. § 7482.

within the meaning of sec. 23 (a), Internal Revenue Code of 1939.[2]

During the taxable years, the taxpayer, Charles V. Doyle, hereinafter referred to as respondent,[3] was engaged in accepting wagers on horse races, herein referred to as bookmaking or operating a handbook, in the state of Illinois. Respondent paid rent for a room in Chicago where he accepted, recorded and paid the wagers. In the conduct of this business respondent paid wages to several employees.

The Commissioner contends that the Tax Court erred in allowing these amounts to be deducted from the gross income of the respondent.

The blueprint for this decision is to be found in sec. 23 of the Internal Revenue Code of 1939.[4] Relevant provisions thereof read as follows:

> § 23. Deductions from gross income.
>
> In computing net income there shall be allowed as deductions:
>
> (a) [as amended by Sec. 121 (a), Revenue Act of 1942, c. 619, 56 Stat. 798]. *Expenses.*
>
> (1) *Trade or business expenses.*
>
> (A) *In general.* All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * * and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

---

[2] 26 U. S. C. A. § 23 (a).

[3] Clara Doyle is a party by reason of filing joint returns with her husband, the respondent. She will not be further referred to in this opinion.

[4] 26 U. S. C. A. § 23.

Sec. 23 (a), in setting forth what trade or business expenses are to be deducted from gross income in computing net income, makes no distinction between lawful and unlawful disbursements. The act says that there shall be allowed as deductions all ordinary and necessary expenses paid or incurred in carrying on any trade or business, including a reasonable allowance for salaries and rentals for use of property for purposes of the trade or business.

Both parties agree that gross income includes income from a trade or business regardless of its lawfulness or unlawfulness. But the Commissioner would include the element of lawfulness of expenses of rent and salaries of a trade or business as a requirement for their deductibility, in addition to the act's requirement that said expenses be "ordinary and necessary". Here is "clear Congressional action" contrary to the Commissioner's position. *Textile Mills Securities Corp.* v. *Commissioner*, 314 U. S. 326, at page 328, 62 S. Ct. 272, 86 L. Ed. 249. The Commissioner would have us add the word "lawful" in the guise of judicial construction. This is a taxing statute. The congress by this act purposed the raising of revenue rather than the furnishing of aid to the enforcement of the state's criminal laws. In imposing an income tax, the congress draws no distinction between income from a lawful business and income from an unlawful business. It is not concerned with the source.

The language of sec. 23 is clear and unambiguous. Its application to this case requires an affirmance of the Tax Court's decision. However, because of the exhaustive brief filed by the Commissioner, in which he attempts to justify his contention that the Tax Court erred, we shall not end this opinion at this point; but shall discuss the Commissioner's argu-

ments and the principal cases upon which he relies.

In the situation in which we find ourselves, we have no right to let our natural antipathy to respondent, because of the unlawfulness of his business, deter us from objectively applying the law as it is written. Lawful or unlawful, the government has seen fit to impose a tax upon respondent's business. That business, like most businesses, has intake and out-go. The Commissioner would have us consider that business as divided into three parts: (1) the gross income, (2) the amounts paid for salaries and rent, and (3) other expenses of the business. As we shall see, the Commissioner, in computing respondent's income tax, takes into account (1) and (3) and discards (2). This is confusing because (2) is expressly recognized as a proper deduction by sec. 23 (a), and (3) is also recognized, but not specifically. However the business is not susceptible to the assumed division. The business, whose income the government seeks to tax, is a unit. Its income is as unlawful as any of its ordinary and necessary expenses. They are all integral parts of a whole tree whose fruit the Commissioner would tax. He is inconsistent when he concedes that the following expenses in part (3) are deductible: lights, forms and scratch sheets, repairs, supplies, telephone, wall sheets, armored express, wire service, safety tickets, depreciation, auditing, currency exchange, stationery and printing, laundry, etc., totalling for 1948, $6,903.53, for 1949, $6,615.59, and for 1950, $6,357.43.

From sec. 23 (a) we find that an allowable deduction claimed for an expense in carrying on a business must be ordinary and necessary, nothing more or less. In what amounts to a partial recognition that this is true, the Commissioner admits as proper deductions respondent's expenses for telephone, printing

and other items, none of them specifically mentioned in the act. It is clear that salaries and rent are ordinary and necessary to the carrying on of the business of a handbook just as the admitted expenses are. Moreover, the act specifically mentions salaries and rent. Economically they are as much an integral part of the business as is the receipt by the handbook operator of moneys paid on bets.

We construe the statutory words "ordinary and necessary expenses" to mean those expenses which economically are an integral part of a business, whether it be lawful or unlawful. Integrality is the test. Disbursements which fail to meet this test, although they may be concomitants to the business as operated by some persons, are not ordinary and necessary expenses thereof within the meaning of sec. 23 (a). We exclude and, therefore, hold as nondeductible, expenses which are not an integral part of a business. In this class fall bribes paid to public officers,[5] fines and penalties imposed for violations of federal or state statute,[6] expenses for certain types of lobbying and political pressure activities,[7] payments to an influential party precinct captain, in order to obtain a state printing contract[8] and other similar disbursements.[9]

As illustrative, we find it helpful to apply the test to two simple situations. An ordinary grocer, who

---

[5] *United States* v. *Sullivan*, 274 U. S. 259, 261, 47 S. Ct. 607, 71 L. Ed. 1037.

[6] *Great Northern Ry. Co.* v. *Commissioner*, 8 Cir., 40 F. 2d 372 and *Lentin* v. *Commissioner*, 7 Cir., 226 F. 2d 605.

[7] *Textile Mills Securities Corp.* v. *Commissioner*, 314 U. S. 326, 62 S. Ct. 272, 86 L. Ed. 249.

[8] *Rapid* v. *Commissioner*, 8 Cir., 127 F. 2d 393.

[9] *See Commissioner of Internal Revenue* v. *Heininger*, 320 U. S. 467, 64 S. Ct. 249, 88 L. Ed. 171, affirming this court, 123 F. 2d 567.

bribes a policeman to let him place his wares on a public sidewalk in front of his store in violation of a municipal ordinance, cannot deduct the amount of the bribe as an ordinary and necessary expense of his grocery business. The payment is a concomitant, but not an integral part, of the grocery business. If a handbook operator takes over the store used by the grocer and bribes the same policeman to permit the placing of chairs for the bettors on the same sidewalk in violation of the same ordinance, that payment would for the same reason be nondeductible. The payment is a concomitant, but not an integral part, of the handbook business. Both the grocer and the handbook operator, during their respective occupancies of the store, would be entitled to deduct on their income tax returns expenditures for salaries of clerks, rent of the store and other ordinary and necessary expenses of their businesses, because such payments are an integral part of the business.

To the extent that such ordinary and necessary expenses exist, a holding that they are undeductible by a handbook operator in a state in which the business is unlawful, would mean that such a tax would be levied by the federal government on gross income, while a holding that they are deductible in a state in which the business is lawful, would mean that such a tax would be levied on only net income. We cannot believe that the congress intended this inequitable result. Certainly the clear language of the act does not suggest that such consequences were contemplated by the congress.

Other examples illustrate the fallacy of the Commissioner's contention. Thus one state may prohibit the business of selling automobiles on Sunday, while another may not. Would the Commissioner argue that a dealer who did business on Sunday in the first

state could not deduct from his gross receipts salaries and rent paid for his unlawful activity on that day, while a dealer in the second state could make such deductions? In some areas the sale of intoxicating liquor at retail is legal, and in others it is illegal. Would a retailer's salary and rent payments be deductible or not depending entirely on the lawfulness of his business?

Cases might arise in which the charge of unlawfulness might be denied. In the absence of a criminal trial to resolve the question of the taxpayer's guilt, is that question to be tried by the Commissioner and the Tax Court in tax proceedings? Such a situation might arise from the Commissioner's argument, based on the Illinois statute's provision that an owner, who knowingly permits his property to be used for gambling, shall be subject to punishment, and the further provision that an accessory to the perpetration of a crime shall be punished as a principal. He argues that respondent, in paying rent for his leased handbook premises, is an accessory to the crime of the landlord. If this theory is tenable, someone must determine whether the landlord *knowingly* permitted the illegal use of his premises. Is this question to be determined in a proceeding to which the landlord is not a party? If so, who is to make that determination—the Commissioner and the Tax Court? Those questions are suggestive of the many surprising results which would follow the adoption of the Commissioner's theories. We cannot believe that they were intended by the congress. The clear language of sec. 23 is a bar to such excursions as the Commissioner's contentions would invite.

The Commissioner should have allowed salaries and rent as deductions under sec. 23 (a). Hence the Tax Court's decision is correct and is affirmed.

We feel that it is important to call the attention of the Commissioner to the fact that in this and other cases before us his counsel repeatedly ignore rule 16 (c), (d) and (e), of this court regulating the contents of briefs.

Affirmed.

FINNIGAN, *Circuit Judge* (dissenting).

Book-making is a statutory criminal offense in Illinois. Ill. Rev. Stat. 1955, chap. 38, § 336. It is undisputed that appellee Charles V. Doyle operated "a bookmaking establishment" in that State for the tax years involved. Shortly stated the question is, can Doyle's disbursements for salaries and rents incurred in his illegal enterprise be classed "ordinary and necessary" under § 23 (a) (1), Internal Revenue Code of 1939. Under the Illinois statute Doyle's expense items are unnecessary, though perhaps ordinary. But for deductibility as business expenses in computing federal income taxes, the Congressional mandate requires both elements—ordinary and necessary. I am unable to ignore the public policy of Illinois manifested by its statute proscribing the behavior generating Doyle's items of rent and salaries. The "temerity to raise" such deductibility was long ago anticipated in another case. *United States* v. *Sullivan*, 1927, 274 U. S. 259, 264, 47 S. Ct. 607, 71 L. Ed. 1037. I would reverse the Tax Court decision and remand this case with directions to disallow the deductions claimed.

LIBRARY
SUPREME COURT, U.S.

Office - Supreme Court, U.S.
FILED
JUN 10 1957
JOHN T. FEY, Clerk

IN THE

Supreme Court of the United States

OCTOBER TERM, 1956

No. ~~986~~ 119

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

NEIL SULLIVAN AND GRACE SULLIVAN.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

JAMES ROSS AND ANN ROSS.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

SAM MESI.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF FOR RESPONDENTS IN OPPOSITION.

E. J. BLAIR,
EUGENE BERNSTEIN,
77 W. Washington Street,
Chicago 2, Illinois,
Attorneys for Neil Sullivan, Grace Sullivan, James Ross and Ann Ross.

HOWARD R. SLATER,
77 W. Washington Street,
Chicago 2, Illinois,
Attorney for Sam Mesi.

INDEX.

	PAGE
Question presented	2
Statement	2
Reasons for not granting the Writ	3
Conclusion	14
Appendix A	15
Illinois Revised Statutes, Chapter 38, Sec. 336 Criminal Code of State of Illinois	15
Kansas General Statutes, Chapter 21, Paragraph 21-1519	16
Appendix B	18
Revenue Ruling 54-219, Internal Revenue Cumulative Bulletin 1954-1, page 51	18

CITATIONS.

Cases:

Burnet v. Harmel, 287 U. S. 103	3
Comeaux, 6 A. 10 T. C. 201	9
Comeaux v. Commissioner, 176 F. 2d 394	10
Commissioner v. Doyle, 231 F. 2d 635	5, 11
Commissioner v. Heininger, 320 U. S. 467	4, 12, 13
Federal Communications Commission v. American Broadcasting Co., 347 U. S. 284	13, 14
Fullawider v. So. Pac. R. R. Co., 248 U. S. 409	5
Heininger v. Commissioner, 133 F. 2d 567	13
Lilly v. Commissioner, 343 U. S. 90	3
Mesi, Sam, 25 T. C. 513	2
Textile Mills Security Corp. v. Commissioner, 314 U. S. 326	3, 4
U. S. v. Kahriger, 345 U. S. 22	7

Statutes:

Illinois Revised Statutes, Ch. 38, Sec. 326 ..... 11, 12
Internal Revenue Code of 1939, Sec. 23(a) (26 U. S. C. 1952 ed., Sec. 23(a)) 11, 12
Internal Revenue Code 1951, Sec. 3285 7
Internal Revenue Code 1951, Sec. 3290 7
Internal Revenue Code 1951, Sec. 3291 7
(Sec. 4401-5, 4411-14 Int. Rev. Code 1954.)
Kansas General Statutes, Chapt. 21, par. 21-4519 ..... 9, 10, 11

Miscellaneous:

50 Cong. Rec. 3849 6
50 Cong. Rec. 3850 6
House Report 704, p. 22, 73d Cong. 2nd Sess. 6, 7
House Report 586, p. 55, 82d Cong. 1st Sess. 8
97 Cong. Rec. 12230-31 8
97 Cong. Rec. 12240 8
97 Cong. Rec. 12244 8
Revenue Ruling 54-219, Internal Revenue Cumulative Bulletin, 1954-1; page 51. 11
Senate Report 781, p. 113, 82d Cong. 1st Sess. 8
Senate Report 781, p. 120, 82d Cong. 1st Sess. 9

IN THE

Supreme Court of the United States

OCTOBER TERM, 1956.

No. 983.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

NEIL SULLIVAN AND GRACE SULLIVAN.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

JAMES ROSS AND ANN ROSS.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

SAM MESI.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF FOR RESPONDENTS IN OPPOSITION.

Respondents present this collective brief in opposition to the single petition filed to review the judgments below. The petition adequately states the Opinions Below, Jurisdiction and Statutes Involved.

QUESTION PRESENTED

Respondents conducted bookmaking businesses in Illinois, a state in which such activity is unlawful. In the operation of such businesses they made payments for the rental of the premises within which such businesses were conducted and for the wages of their employees.

The question is whether the expenses of rent and wages, specifically allowable as deductions in computing net income under the provisions of Sections 23 (a) (1) (A) of the Internal Revenue Code of 1939, are nonetheless not deductible because the trade or business within which they were incurred was illegal under the provisions of the law of the state within which the business was conducted.

STATEMENT

Except for the noted exceptions, the Statement in the petition is adequate. The exceptions are:

The conclusion relating to the *Ross* and *Sullivan* cases that "The payment of the wages and rent constituted a violation of Section 582 of the [Illinois Criminal] Code." (Pet. 7);

The conclusion relating to the *Mesi* case that "the payment of the wages, in and of itself, constituted an illegal act." (Pet. 8.)

No cited Illinois statute makes illegal the payment of rent and wages. This issue will be discussed in the following section of this brief.

The Statement also fails to point out that the decision of the Tax Court, in the *Mesi* case, was by a divided court, and that Judges Murdock, Tietjens and Atkins dissented. 25 T. C. 513.

REASONS FOR NOT GRANTING THE WRIT.

Perhaps the general question of the deductibility of expenses under Section 23(a) of the 1939 Internal Revenue Code (Section 162 (a) of the 1954 Code) which are in conflict with "public policy" is one which might well be clarified by this Court. But that question is not presented by these cases. These cases involve expenses for rent and salaries which are specifically enumerated in the statute as being included within the statutory expression "ordinary and necessary". Congress has on many occasions acknowledged that gambling, whether legal or illegal in the state where carried on, is a trade or business; and has also clearly indicated that expenses incurred in such pursuit are deductible on the same basis as the expenses of any other business.

Thus since the statute is clear there is no room for the application of any other "public policy" including that of a state, as expressed in its statutes, since the federal policy as expressed in the tax statute and by Congressional intent is certainly paramount. "Here we are concerned only with the meaning and application of a statute enacted by Congress, in the exercise of its plenary power under the constitution, to tax income. The exertion of that power is not subject to state control. It is the will of Congress which controls * * *" *Burnet* v. *Harmel*, 287 U. S. 103, 110 (1932).

Prior Supreme Court Decisions. The teaching of the prior decisions of this Court concerning the relationship between Section 23(a) and "public policy" is plain; only where the Congressional intent is not clear may a general policy be applied to interpret the statute. Thus in *Textile Mills Security Corp.* v. *Commissioner*, 314 U. S. 326 (1941), the Court stated, in upholding the disallowance as deductions under Section 23(a) of payments for lobbying and propaganda to procure passage of legislation permitting

the recovery of properties seized during World War I under the Trading With the Enemy Act:

> "Contracts to spread such insidious influences through legislative halls have long been condemned * * * Whether the precise arrangement here in question would violate the rule of those cases is not material. The point is that the general policy indicated by those cases need not be disregarded by the rule-making authority in its segregation of non-deductible expenses. There is no reason why, *in absence of clear Congressional action to the contrary*, the rule-making authority cannot employ that general policy in drawing a line between legitimate business expenses and those arising from that family of contracts to which the law has given no sanction. The exclusion of the latter from 'ordinary and necessary' expenses *does no violence to* the statutory language." 314 U. S. 326, 338-339. (Emphasis added.)

Neither *Lilly* v. *Commissioner*, 343 U. S. 90 (1952) nor *Commissioner* v. *Heininger*, 320 U. S. 467 (1943)—the two other decisions relating to public policy and Section 23(a)—is inconsistent with the holding in *Textile* that Congressional intent is paramount, and only in the absence of clear Congressional action to the contrary may a general policy be applied in determining deductibility of expenses. "Our enquiry is therefore limited to the narrow issue of whether these expenses were 'ordinary and necessary' within the meaning of Section 23(a)," said the Court in *Heininger*, 320 U. S. 467, 470. And in *Lilly* the Court again framed the issue as being one involving the interpretation of Section 23(a). "In such a case [where the expenses violated or were incidental to violation of state or federal law] it could be argued that the outlawed expenditures, by virtue of their illegality, were not 'ordinary and necessary' business expenses within the meaning of § 23(a)(1)(A)." 343 U. S. 90, 94-95. Here again, the meaning of the statute is paramount.

It is because Section 23(a) did not clearly permit the deduction of expenditures for bribes, penalties, fines, lobbying, defense of fraud charges, or "kickbacks" to opticians by eye glass manufacturers that courts have permitted consideration of the "public policy" issue when such deductions were questioned. Some of these expenditures were allowed; others were not. But these decisions do not evidence any conflict with the decisions of the Court of Appeals in the present cases, for these are areas where there has been no "clear Congressional action to the contrary," in the words of *Textile*. These "public policy" decisions do not establish the proposition that the deductibility of an expenditure is solely dependent on policy considerations no matter what the statute provides, but rather that only if the statute does not plainly cover the deduction may another policy be looked to. "We may grant, if a policy exists, that it may be used to resolve the uncertainty of a law, but it cannot be a substitute for a law." *Fullinwider* v. *So. Pac. R. R. Co.*, 248 U. S. 409, 412 (1919).

The holding of the Court of Appeals for the Seventh Circuit in *Commissioner* v. *Doyle*, 231 F. 2d 635 (C. A. 7, 1956), upon which decision the decisions in the present cases were predicated, was simply that here there had been clear congressional action to the contrary—"The language of Sec. 23 is clear and unambiguous." 231 F. 2d 635, 636.

On this issue—the meaning of Section 23(a)—the petitioner is silent, except to state that in the Government's view, "the words 'trade or business' as used in Section 23 mean a lawful enterprise and do not cover criminal activities." (Pet. 14.)

It is somewhat unclear whose governmental view this is—since it is certainly not that of Congress nor the Commissioner nor the Tax Court (until the present cases).

Congressional Intent. During consideration of the Revenue Act of 1913, discussion was had in the Senate on the use of the term "trade" in the section of the Act which was the forerunner of Section 23(a). A question was raised about illegal or illegitimate trade and an amendment was offered to add the qualifying words "ordinary and legitimate" before the word "trade". The amendment was rejected. 50 Cong. Rec. 3850.

During the course of the debate on this subject, the purpose of the bill was explained:

> "* * * The object of this bill is to tax a man's net income; that is to say, what he has at the end of the year after deducting from his receipts his expenditures and losses. It is not to reform men's moral characters; that is not the object of the bill at all. The tax is not levied for the purpose of restraining people from betting on horses or upon 'futures', but the tax is framed for the purpose of making a man pay upon his net income, his actual profit during the year. The law does not care where he got it from, so far as the tax is concerned, although the law may very properly care in another way." 50 Cong. Rec. 3849.

In 1934 there first appeared in the Internal Revenue Code the present Section 165 (d), that "Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions." This was Section 23(h) in the 1939 Code, and Section 23(g) when it first appeared in the Revenue Act of 1934. The House Committee Report on the 1934 Revenue Act stated with reference to the new Section:

> "Existing law does not limit the deduction of losses from gambling transactions where such transactions are legal. Under the interpretation of the courts, illegal gambling losses can only be taken to the extent of the gains on such transactions. *A similar limitation on losses from legalized gambling is provided for in*

> *the bill.* Under the present law many taxpayers take deductions for gambling losses but fail to report their gambling gains. This limitation will force taxpayers to report their gambling gains if they desire to deduct their gambling losses." (Emphasis added.) House Report 704, p. 22, 73d Cong., 2d Sess. (1934).

Since this section was intended to relate to illegal as well as legal gambling, it is clear that the petitioner's statement that Section 23 relates to lawful enterprises only is a view not shared by Congress.

The Congressional intent, if not yet crystal clear, became so with the adoption of the Revenue Act of 1951. It was in this Act that first appeared the 10% excise tax on gross receipts from wagering, Section 3285 Internal Revenue Code of 1951, and the $50 tax and registration requirement for all persons engaged in the business of wagering, Sections 3290 and 3291 of Internal Revenue Code of 1951 (Sections 4401-5, 4411-14, Internal Revenue Code of 1954). These measures were adopted in the wake of the activities of the Special Senate Committee to Investigate Organized Crime in Interstate Commerce, and one of the admitted objects of the 10% excise tax on wagering and the registration requirements was to inhibit the business of gambling. *See United States* v. *Kahriger*, 345 U. S. 22, 27, 35 (1953), upholding the constitutionality of the wagering excise tax.

During the debate on these new sections, Senator Kefauver expressed opposition on the ground that the excise tax and $50 special tax might be construed as a license to violate state law. He offered, in lieu of these provisions, an amendment to Section 23(a). He proposed a new paragraph be added as subsection 23(a)(3) as follows:

> "(3) Illegal Wagering. No deduction shall be allowable under paragraph (1) or (2) to a taxpayer for any expense paid or incurred in or as the result of illegal wagering." 97 Cong. Rec. 12230-31.

The opponents of this amendment argued that it presented serious constitutional difficulties. It was noted that the amendment would convert the tax to one on gross rather than net income. The problem of determining illegality for the purpose of this amendment in the absence of a determination of guilt by the local courts was pointed out, and it was suggested that the inevitable result might well be that the Internal Revenue Service would become a co-operating law enforcement agency with local police. 97 Cong. Rec. 12240.

Senator Kefauver's amendment was defeated. 97 Cong. Rec. 12244.

In their reports on the Revenue Act of 1951 both the House and Senate committees commented on the criticism that the new sections might be construed as a license to carry on illegal activities, and in so doing plainly indicated that there is no distinction, insofar as the federal income tax is concerned between legal and illegal business. Thus both Reports state:

> "Since its inception, the Federal income tax has applied without distinction to income from illegal as well as legal sources, and it has never been generally supposed that such application carried with it any implied authorization to carry on illegal activities. Moreover, in the field of excise taxes the tax on coin-operated gambling devices has been applied without regard to whether or not the operation of a particular machine is in violation of State or local law. The present bill conforms to the pattern and imposes tax without regard to the legality or illegality of the particular wager." House Report No. 586, p. 55; Senate Report No. 781, p. 113, 82d Cong. 1st Sess. (1951).

In addition, the Senate Report made further comment on Senator Kefauver's defeated proposal:

"TAX TREATMENT OF ILLEGAL ACTIVITIES.

Several amendments have been proposed to the Committee which would affect the tax treatment of gamblers and other persons who receive income from illegal sources. In summary, these amendments would—

(a) Disallow as a deduction from gross income any expenses incurred in illegal wagering and any losses resulting from illegal wagering;

* * * * *

Your Committee believes that additional time is necessary for detailed study of these suggestions and therefore believes that action on them should not be taken at this time. The Committee is fully aware of the importance of a strict enforcement of the income tax laws in this area." Senate Report No. 781, p. 120, 82d Cong. 1st Sess. (1951).

Position of Tax Court. This plain and unequivocal meaning of Section 23 has been consistently followed by the Tax Court itself, and until the *Mesi* decision (one of the three decisions for which review is here sought) the Tax Court had rejected any attempts by the Commissioner to disallow rent and salary expenses.

For example, in *G. A. Comeaux*, 10 T. C. 201 (1948), the Commissioner attempted to disallow the ordinary and necessary expenses of an illegal gambling business. The taxpayer operated a "horse-book" establishment in Kansas. For the years 1938 to 1944 the Commissioner denied as deductions sums paid certain persons for protection from arrest and prosecution and salaries paid to persons engaged in operating the business, as well as certain miscellaneous expenses. It was found by the Tax Court that this enterprise was illegal under the criminal statutes of Kansas. The Tax Court affirmed the Commissioner's disallowance for protection payments, but reversed his disallowance of

salary and miscellaneous expenses. In pointing out the distinction, the Tax Court stated, at p. 207:

> "The second issue relates to the deduction of salaries and miscellaneous expenses, the 'legitimate expenses of an illegitimate business'. The amount of such items is not in dispute. These expenses were incurred in earning the income reported by petitioner or attributed to him by respondent. In *Anthony Cornero Stralla*, 9 T. C. 891, at 821, this Court recognized that such expenses are deductible, in contra-distinction to those expenses which are not deductible because contrary to public policy. We said: 'The expenditures here in issue were not made in the actual production of the income; deduction of expenses of that character has been allowed.' The income tax law is not a tax on gross income, even if the income be earned in an illegal business. *Commissioner* v. *Heininger*, 320 U. S. 467. The deduction of such expenses depends on the innate character of the item itself. Thus the protection expenses have been disallowed as being contrary to sound public policy or proscribed types of conduct. But items not so to be characterized may be deductible. The distinction may at first seem nebulous, but it is nonetheless real. The items now under discussion are in the latter category and are allowable deductions. The amounts appear in the findings of facts."

The correctness of the position of the Tax Court was affirmed on review of another aspect of the decision in *Comeaux* v. *Commissioner*, 176 F. 2d 394, 400 (C. A. 10, 1949), where the Court said, in passing:

> "The amounts are not in dispute, and it is agreed that while legitimate expenses incurred in an illegitimate business are deductible, amounts paid for protection are not legitimate business expenses. The Tax Court allowed certain claimed expenses incurred in the operation of the business * * *".

Comeaux is particularly significant to the instant cases since the Kansas criminal statute relating to "horse book"

establishments is identical in its operative language with that of Illinois. Compare Ch. 21, Par. 23-1519 Kan. Gen. Stats. and Ch. 38, Section 336 Ill. Rev. Stats. upon which statute petitioner relies here (Pet. 4). (These statutes are set out in Appendix A to this brief.)

The rather recent shift in the attitude of the Tax Court as indicated by its decisions in the present cases is dramatically pointed up by the fact that in *Commissioner* v. *Doyle*, 231 F. 2d 635 (C. A. 7, 1956), the Court of Appeals *affirmed* the Tax Court which had rejected the petitioner's argument that the rent and salary expenses of an Illinois bookmaker should be disallowed. The *Doyle* decision, upon which the Court of Appeals based its decisions in the present cases, is set out at p. 25 of the Petition.

Even now the Commissioner recognizes that gambling—illegal as well as legal—is a trade or business under Section 23 (a) entitled to deduct its ordinary and necessary expenses. Thus in Revenue Ruling 54-219, Cumulative Bulletin 1954-1, p. 51, petitioner has held that the federal excise tax on wagers and the special tax paid by persons engaged in receiving wagers are deductible as ordinary and necessary expenses under Section 23 (a), and no distinction is drawn between legal and illegal gambling enterprises. This Ruling is set out as Appendix B to this Brief.

The Illinois Statute. Petitioner also suggests that if the taxpayers here were engaged in a "trade or business" within the meaning of Section 23, yet expenses for rent and salary are somehow different than other expenses of a bookmaker in Illinois. This issue is hardly separable from what appears to be petitioner's main thesis that the taxpayers were not engaged in a "trade or business," but here petitioner seems to place some peculiar reliance on the very statute which makes the activity illegal in the first instance.

Since Section 23 (a) specifically permits the deduction of "a reasonable allowance for salaries or other compensation for personal services actually rendered" and "rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property" it is irrelevant to respondents' position whether Illinois law specifically makes unlawful the payment of rents and wages in connection with the operation of a bookmaking establishment, itself an unlawful enterprise under Illinois law. However, the fact is that the Illinois statute upon which petitioner relies, Section 336 of the Illinois Criminal Code (Pet. 4; App. A to this Brief) contains no reference to wages or rent. It prohibits the knowing use of premises for the purpose of recording or registering wagers and the recording or registering of wagers. The illegality arises from the *use*, not the payment of wages or rent, and respondents' activities would have been unlawful under the Illinois statute even if the premises had been let rent free, or if their employees had donated their services. Since the business is illegal under this statute, *a fortiori*, all its expenses are illegal—not because any statute declares them to be specifically illegal but because they are incurred in the carrying on of an illegal business. The inevitable logic of petitioner's position would have to be that all expenses of the illegal business would be disallowed and the tax would be on gross income, but this position has been specifically rejected by Congress, as has already been shown in this brief, and rejected by petitioner himself since he allows the deduction of the 10% excise tax and the $50 special tax. (App. B.)

Judicial or Administrative Legislation. What the petitioner seeks here is legislation without benefit of Congress. Commenting on a similar effort when *Commissioner* v. *Heininger*, 320 U. S. 467 (1943) was before the Court of

Appeals, Judge Minton observed that no distinction had been made by Congress or the Bureau of Internal Revenue between income from legal or illegal business. "Both, so far as the statutes and regulations of the Department went, were to be taxed on their net income." He pointed out that although this lack of distinction between legal and illegal business was well known to Congress, no change had been made in the law. (Judge Minton had been a member of Congress when the Revenue Act of 1939 was adopted.) He stated, in his opinion,

> "If this change is to be made and the policy altered, *let Congress do it.* Congress would need only to add the word 'legal' before the word 'trade' in the third line of Section 23 (a)(1).
>
> We are asked, in the guise of construing the words 'ordinary and necessary', to amend the statute. In other words, to engage in a little judicial legislation. We decline the invitation." *Heininger* v. *Commissioner*, 133 F. 2d 567, 570. (Emphasis added.)

The province of petitioner is the enforcement of the federal taxing statute as written by Congress, not the policing of public morals. His efforts here to usurp the legislative functions are similar to those of other administrators.

In *Federal Communications Commission* v. *American Broadcasting Co.*, 347 U. S. 284 (1954), the efforts of the F. C. C. to extend its own powers to accomplish an end which it considered socially desirable were reviewed by the Supreme Court. There the F. C. C. adopted regulations providing for the denial of licenses to radio and television stations broadcasting "give-away" programs. In affirming the judgment of the district court in restraining the enforcement of these regulations, the Court succinctly summarized the issue:

> "It is apparent that these so-called 'give-away' pro-

grams have long been a matter of concern to the Federal Communications Commission; that it believes these programs to be the old lottery evil under a new guise, and that they should be struck down as illegal devices appealing to cupidity and the gambling spirit. It unsuccessfully sought to have the Department of Justice take criminal action against them. Likewise, without success, it urged Congress to amend the law to specifically prohibit them. The Commission now seeks to accomplish the same result through agency regulations. In doing so, the Commission has over-stepped the boundaries of interpretation and hence had exceeded its rule-making power. Regardless of the doubts held by the Commission and others as to the social value of the programs here under consideration, such administrative expansion of § 1304 does not provide the remedy." 347 U. S. 284, 296-97.

CONCLUSION.

For the foregoing reasons, it is respectfully submitted that the petition for a writ of certiorari should be denied.

Respectfully submitted,

E. J. Blaine,
Eugene Bernstein,
77 W. Washington Street,
Chicago 2, Illinois,
Attorneys for Neil Sullivan, Grace Sullivan, James Ross and Ann Ross.

Howard R. Slater,
77 W. Washington Street,
Chicago 2, Illinois,
Attorney for Sam Mesi.

APPENDIX A.

Illinois Revised Statutes.

Chapter 38, Criminal Code of State of Illinois:

"336. Book-making and pool-selling unlawful.

§ 1. *Be it enacted by the People of the State of Illinois, represented in the General Assembly:* That any person who keeps any room, shed, tenement, tent, booth, or building, or any part thereof, or who occupies any place upon any public or private grounds within this state, with any book, instrument or device for the purpose of recording or registering bets or wagers, or of selling pools, or any person who records or registers bets or wagers, or sells pools upon the result of any trial or contest of skill, speed or power of endurance of man or beast, or upon the result of any political nomination, appointment or election, or being the owner, lessee, or occupant of any room, shed, tenement, tent, booth, or building, or part thereof, knowingly permits the same to be used or occupied for any of these purposes, or therein keeps, exhibits or employs any device or apparatus for the purpose of recording or registering such bets or wagers, or selling of such pools, or becomes the custodian or depository for hire or privilege, of any money, property, or thing of value staked, wagered or pledged upon any such result, shall be punishable by imprisonment in the county jail for a period not longer than one year, or by fine not exceeding $2,000 or both. Provided, however, that the provisions of this act shall not apply to the actual enclosure of fair or race track associations that

are incorporated under the laws of this state, during the actual time of the meetings of said associations, or within twenty-four hours before any such meetings."

Kansas General Statutes:

"Ch. 21, Par. 21-1519.

"*Bookmaking or selling pools, or permitting on premises; penalty.* That any person who keeps any room, shed, tenement, booth or building, or any part thereof, or who occupies any place upon any public or private grounds within this state with any book, instrument or device for the purpose of recording or registering bets or wagers or selling pools, upon the result of any trial or contest of skill, speed or power of endurance of man or beast which is to be made to take place within or beyond the limits of this state, except within the inclosure of a race track and upon races or trials of speed being conducted within said inclosure (provided that the exception herein shall not apply to any race track or inclosure for more than two weeks in any one year), or any person who records or registers bets or wagers, or sells pools upon the result of any trial or contest of skill, speed or power of endurance of man or beast, which is to be made or take place within or beyond this state; or upon the results of any political nomination, appointment or election which is to be made or held either within or beyond the limits of this state, or being the owner, lessee or occupant of any room, shed, tenement, booth or building, or part thereof, knowingly permits the same to be used or occupied for any of the purposes hereinbefore prohibited, or therein keeps, exhibits or employs any device or apparatus for the purpose of registering such bets or wagers, or selling pools, as are hereinbefore prohibited, or becomes the custodian

or depositary for hire or privilege of any money, property or thing of value which is staked, wagered or pledged contrary to the provisions of this act, shall be guilty of a misdemeanor, and on conviction shall be punished by imprisonment in the county jail for a period of one year and by a fine of one thousand dollars."

APPENDIX B.

Revenue Ruling 54-219, Internal Revenue Cumulative Bulletin 1954-1, page 51.

"Regulations 118, Section 39.23(a)-1: Rev. Rul. 54-219 Business Expenses.

"The Federal excise tax on wagers under section 3285(d) of the Internal Revenue Code and the special tax under section 3209 of the Code paid by persons engaged in receiving wagers are deductible, for Federal income tax purposes, as ordinary and necessary business expenses under section 23(a) of the Internal Revenue Code, provided the taxpayer is engaged in the business of accepting wagers or conducting wagering pools or lotteries, or is engaged in receiving wagers for or on behalf of any person liable for the tax under section 3285(d) of the Code."

Supreme Court, U.S.
FILED
OCT 25 1957
JOHN T. FEY, Clerk.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1957.

No. 119

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

NEIL SULLIVAN AND GRACE SULLIVAN.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

JAMES ROSS AND ANN ROSS.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

SAM MESI.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF FOR RESPONDENTS.

E. J. BLAIR,
EUGENE BERNSTEIN,
77 W. Washington Street,
Chicago 2, Illinois,
Attorneys for Neil Sullivan, Grace Sullivan, James Ross and Ann Ross.

HOWARD R. SLATER,
77 W. Washington Street,
Chicago 2, Illinois,
Attorney for Sam Mesi.

INDEX.

	PAGE
Question presented	2
Summary of argument	2
Argument	4
1. "Public policy" may be used to resolve the uncertainty of an ambiguous statute, but has no application where the meaning of the statute is clear	4
2. Section 23(a)(1)(A) of the Internal Revenue Code of 1939, by its clear and unambiguous terms, requires the allowance of the deductions claimed	9
3. Prior Tax Court decisions affirm the plain meaning of the statute	11
4. Petitioner's theory that deductions under Section 23(a) are dependent upon state law is refuted by legislative history, and if adopted would cast doubt upon the constitutionality of the statute	21
5. Petitioner's theory of "independently illegal" expenses is not supported by state law	29
6. Petitioner has attempted to usurp the legislative function, and hence has acted beyond the scope of his authority	36
Conclusion	40
Appendix A	41
Revenue Ruling 54-219, Internal Revenue Cumulative Bulletin 1954-1, page 51	41
Appendix B	42
Illinois Revised Statutes, Chapter 38, Sec. 336, Criminal Code of State of Illinois	42
Kansas General Statutes, Chapter 21, Paragraph 21-1510	43

CITATIONS.

Cases.

Appeal of McKenna, 1 B. T. A. 326 ..... 11, 12, 13
Boyle, Flagg & Seaman, Inc. v. Commissioner, 25 T. C. No. 8 10
Burnet v. Harmel, 287 U. S. 103 7
Clark, Charles A., v. Commissioner, 19 T. C. 48 19
Comeaux v. Commissioner, 10 T. C. 201, affirmed 176 F. 2d 394 ..... 15, 16, 17, 24
Comeaux v. Commissioner, 176 F. 2d 394 17
Commissioner v. Doyle, 231 F. 2d 635 ..... 9, 20
Commissioner v. Heininger, 320 U. S. 467 ..... 4, 5, 6, 10, 11
Doyle, Charles V., v. Commissioner, P-H T. C. Memo. Par. 54,340 19
Federal Communications Commission v. American Broadcasting Co., 347 U. S. 284 37
Federika, Jack, v. Commissioner, P-H T. C. Memo. Par. 55,172 18
Fullenwider v. So. Pac. R. R., 248 U. S. 409 9
Gunn v. Dallman, 171 F. 2d 36, cert. den. 336 U. S. 937. 7
Hackerman v. Commissioner, P-H T. C. Memo. Par. 54,151 18
Heiner v. Mellon, 304 U. S. 271 7
Heininger v. Commissioner, 133 F. 2d 567, aff'd. 320 U. S. 467 23
Helvering v. Powers, 293 U. S. 214 38
Hoefeld v. Oziello, 290 Ill. 147 ..... 33, 34
Humphrey v. Commissioner, 162 F. 2d 853, cert. den. 332 U. S. 817 13
Koshland v. Helvering, 298 U. S. 441 38

Lentin v. Commissioner, 226 F. 2d 695 10
Lilly v. Commissioner, 343 U. S. 90 ..... 4, 5, 6
Lux, Jack, v. Commissioner, P-H T. C. Memo. Par. 54,203 18
Lyeth v. Hoey, 305 U. S. 188 7
Manhattan General Equipment Co. v. Commissioner, 297 U. S. 129 38
Marquette Cement Mfg. Co. v. Federal Trade Commission, 147 F. 2d 589 37
McKeown Bros. Co. v. Ogden Kennel Club, 269 Ill. App. 622 33
Pedone v. United States, 151 F. Supp. 288 8
People v. Dorman, 415 Ill. 385 35
People v. Viskniskki, 155 Ill. App. 292 34
Silberman v. Commissioner, 44 B. T. A. 600 ..... 8, 13, 14, 15
Simon, Louis A., v. Commissioner, P-H T. C. Memo. Par. 55,324 18
Stralla v. Commissioner, 9 T. C. 801 ..... 15, 17
Tank Truck Rentals, Inc. v. Commissioner, 243 F. 2d 14, pending on Writ of Certiorari No. 109 ..... 35, 36
Textile Mills Securities Corp. v. Commissioner, 314 U. S. 326 ..... 4, 5, 6, 9, 10
Thomas v. Commissioner, 16 T. C. 1417 18
Thomas v. Perkins, 301 U. S. 655 7
Tinsley v. Commissioner, P-H T. C. Memo. Par. 54,225 18
Truman v. Commissioner, P-H T. C. Memo. Par. 49,027 18
United States v. Calamaro, 354 U. S. 351 28
United States v. Calamaro, 236 F. 2d 182 28
United States v. Constantine, 296 U. S. 287 ..... 26, 28
United States v. Gilbert Associates, Inc., 345 U. S. 361 7
United States v. Halseth, 342 U. S. 277 38

United States v. Kahriger, 345 U. S. 22 ..... 22, 28, 39
United States v. Northern Pacific Ry. Co., 242 U. S. 190 40
United States v. Pelzer, 312 U. S. 399 7
United States v. 200 Barrels of Whiskey, 95 U. S. 571 38
Western Union v. Lenroot, 323 U. S. 490 38
Woolworth Co. v. Kavanaugh, 102 F. Supp. 9 8

Statutes:

Defense Production Act of 1950, Sec. 405(a) 8
Illinois Revised Statutes (1945) Ch. 38 (Criminal Code):
Sec. 139 35
Sec. 140 35
Sec. 336 ..... 14, 17, 19, 20, 34, 35, 42
Internal Revenue Code of 1939:
Sec. 23(a) 11
Sec. 23(h) 12, 15, 22
Internal Revenue Code of 1951:
Sec. 3285 22
Sec. 3290 22
Sec. 3291 22
Internal Revenue Code of 1954, Sec. 165(d) 12, 13
Kansas General Statutes, Ch. 21, par. 21-1510 ..... 16, 17, 18, 20, 43
Purdon Pa. Stats., Title 18, Sec. 5105 36
Revenue Act of 1913, Sec. II(A) and (G)(b) 21
Revenue Act of 1934, Sec. 23(g) 12, 22
Stabilization Act of 1942, Sec. 5(a) 8

Miscellaneous.

Reports of American Bar Association (1953), Vol. 78, p. 338 ..... 38, 39
Brief for Tank Truck Rentals in No. 109, p. 40 36
50 Cong. Rec. 3849 22
50 Cong. Rec. 3850 21
97 Cong. Rec. 12230-31 25
97 Cong. Rec. 12238-39-40 ..... 25, 26, 27
97 Cong. Rec. 12244 27
House Report 704, 73d Cong. 2nd Sess. (1934) (Cum. Bull. 1939-1, Part 2, pp. 554, 570) 12
House Report 586, p. 55, 82nd Cong. 1st Sess. (1951) . 23
Paul, The Use of Public Policy by the Commissioner in Disallowing Deductions, U. of So. Cal. School of Law Tax Institute (1954), p. 715 39
Revenue Ruling 54-219 (Cumulative Bulletin 1954-1, page 51) 11, 41
Senate Report 781, p. 113, 82nd Cong. 1st Sess. (1951) 23
Senate Report 781, p. 120, 82nd Cong. 1st Sess. (1951) 23, 24
1948-1 Cum. Bull. pp. 1, 3, page iv 17

IN THE

Supreme Court of the United States

OCTOBER TERM, 1957.

No. 119.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

NEIL SULLIVAN AND GRACE SULLIVAN.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

JAMES ROSS AND ANN ROSS.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

SAM MESI.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF FOR RESPONDENTS.

Petitioner's Brief adequately presents the Opinions Below, Jurisdiction, Statutes Involved and Statement.

QUESTION PRESENTED.

Respondents conducted bookmaking businesses in Illinois, a state in which such activity is unlawful. In the operation of such businesses they made payments for the rental of the premises within which such businesses were conducted and for the wages of their employees.

The question is whether the expenses of rent and wages incurred in the operation of the trade or business, and specifically allowable as deductions from gross income in computing net income under the provisions of Section 23(a)(1)(A) of the Internal Revenue Code of 1939, are nonetheless not deductible because of Illinois statutes relating to criminal law.

SUMMARY OF ARGUMENT.

Section 23(a) of the Internal Revenue Code of 1939 by its plain, unambiguous provisions, permits the deduction from gross income of all ordinary and necessary expenses incurred in a trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered and for rent. The expenses claimed here by respondents are for wages incurred in the operation of their illegal bookmaking businesses, and for rent incurred in the operation of one of these businesses. There is no issue raised as to either the amount of the claimed deductions nor whether they were incurred in a trade or business. Since an unlawful trade or business is within the purview of Section 23(a), there is no basis upon which the claimed deduction can be disallowed.

The "public policy" argument upon which petitioner relies to deny the deductions is inapplicable since there is no ambiguity in the statute justifying the application of any other policy than that established by its provisions.

Cases relied upon by petitioner proceed from the assumption that application of another policy does no violence to the provisions of the statute. Many of these cases, in fact, distinguish expenses denied on the grounds of public policy from the very kind of expenses here claimed by respondents, expenses which have always been held to be deductible, even when incurred in an unlawful business.

The Tax Court and the Commissioner, until the present cases, have consistently allowed the deduction of expenses by an unlawful business without regard to the legality of the business or the expense, so long as the expenses were otherwise ordinary and necessary.

The legislative history of Section 23(a) and other sections relating to the taxability of unlawful gambling enterprises supports the clearly expressed statutory language that no distinction is drawn for purposes of taxation between lawful and unlawful businesses or lawful and unlawful expenses.

If Section 23(a) were to be construed to exclude from its provisions, because of the operation of state criminal law, expenses otherwise clearly ordinary and necessary, the statute would be of doubtful constitutionality.

Petitioner's theory of "independently illegal" expenses is not supported by the statute, by Congressional intent, by prior decisions or by Illinois law.

Petitioner's position is motivated by the fact that respondents' businesses were unlawful, and in seeking to tax them on a basis different from other taxpayers he usurps the legislative function and assumes a power which he does not have.

ARGUMENT.

1. "Public Policy" May Be Used to Resolve the Uncertainty of an Ambiguous Statute, But Has No Application Where the Meaning of the Statute Is Clear.

This Court has considered the relationship between public policy and Section 23(a) in *Textile Mills Securities Corp.* v. *Commissioner*, 314 U. S. 326 (1941), *Commissioner* v. *Heininger*, 320 U. S. 467 (1943) and *Lilly* v. *Commissioner*, 343 U. S. 90 (1952).

In only one of these, *Textile*, was the claimed deduction disallowed. There the Commissioner had disallowed as deductions under Section 23(a) payments for lobbying and propaganda to procure passage of legislation permitting the recovery of properties seized during World War I under the Trading with the Enemy Act. The Tax Court had reversed the Commissioner, and the Court of Appeals for the Third Circuit had reversed the Tax Court. In affirming the disallowance of the deduction, this Court clearly pointed out that the general policy against lobbying came into play only because the statute did not clearly authorize such deductions, and indicated that had Congress provided otherwise, the general policy would not have applied. On this subject the Court stated:

> "Contracts to spread such insidious influences through legislative halls have long been condemned * * * Whether the precise arrangement here in question would violate the rule of those cases is not material. The point is that the general policy indicated by those cases need not be disregarded by the rule-making authority in its segregation of non-deductible expenses. There is no reason why, *in absence of clear Congressional action to the contrary*, the rule-making authority

> cannot employ that general policy in drawing a line between legitimate business expenses and those arising from that family of contracts to which the law has given no sanction. The exclusion of the latter from 'ordinary and necessary' expenses certainly *does no violence* to the statutory language. The general policy being clear it is not for us to say that the line was too strictly drawn." 314 U. S. 326, 338-339. (Emphasis added.)

In *Heininger* the Commissioner attempted to disallow the deduction of expenses incurred in the unsuccessful defense of a Post Office fraud charge. This Court affirmed the reversal by the Court of Appeals of the Commissioner and Board of Tax Appeals, stating that Section 23(a) contained no express reference to the lawful or unlawful character of the business expenses which are declared to be deductible. In defining the issues, the Court stated:

> "There can be no doubt that the legal expenses of respondent were directly connected with 'carrying on' his business * * * Our inquiry therefore is limited to the narrow issue of whether these expenses were 'ordinary or necessary' within the meaning of Section 23(a)." 320 U. S. 467, 470.

Thus, as in *Textile*, the Court again recognized that legislative intent is paramount.

The *Lilly* decision forcefully stated that "public policy" as such had nothing to do with deductibility of ordinary and necessary expenses under Section 23(a), but rather the question was whether the expenses were "ordinary and necessary" within the meaning of Section 23(a). There the Commissioner attempted to disallow, solely on the basis of public policy, a deduction for "kickbacks" to opticians by eye-glass manufacturers, of one-third of the sales price of eye-glasses sold to the opticians' patients. The Court, in rejecting this "public policy" argument, stated:

> "There is no statement in the Act, or in its accom-

panying regulations, prohibiting the deduction of ordinary and necessary business expenses on the ground that they violate or frustrate 'public policy'.

The Tax Court in the instant case made no finding of fact that the payments to the doctors were not ordinary and necessary business expenses. It sustained the Commissioner's disallowance of their deductibility because it held that, as a matter of law, the contracts under which the payments were made, violated public policy.

We do not have before us the issue that would be presented by expenditures which themselves violated a federal or state law or were incidental to such violations. In such a case it could be argued that the outlawed expenditures, by virtue of their illegality, were not 'ordinary and necessary' business expenses within the meaning of § 23(a)(1)(A)." 343 U. S. 90, 94-95.

The suggestion in *Lilly* that "it could be argued" that expenditures which themselves violated a federal or state law were not "ordinary and necessary" business expenses appears to have been accepted by petitioner as a direction that such expenses are not deductible as a matter of law.

This, of course, is not what was said in *Lilly*, *Heininger*, or *Textile*. In each of these cases it was recognized that Congressional intent is the primary consideration, and only where this intent is not clearly stated—as in *Textile*—could other policy considerations enter into the determination of the deductibility of expenses under Section 23(a). *Textile* clearly held that even though lobbying activities were contrary to "general policy" such expenses were not deductible because of "the absence of clear Congressional action to the contrary." Only because the following of the general policy against such expenditures "does no violence to the statutory language" was the expense disallowed as a deduction. 314 U. S. 326, 338-339.

These principles as applied by this Court in its consideration of Section 23(a) are but a specific application of gen-

eral principles applicable to the whole federal tax scheme and to statutory construction generally.

It has been consistently held that the revenue laws are to be construed in the light of their general purpose to establish a nationwide scheme of taxation uniform in its application.

> "Hence their provisions are not to be taken as subject to state control or limitation unless the language or necessary implication of the section involved makes its application dependent on state law." *United States* v. *Pelzer*, 312 U. S. 399, 402-3 (1941).

In *Burnet* v. *Harmel*, 287 U. S. 103, 110 (1932), the Court stated:

> "Here we are concerned only with the meaning and application of a statute enacted by Congress, in the exercise of its plenary power under the Constitution, to tax income. *The exertion of that power is not subject to state control. It is the will of Congress which controls*, and the expression of its will in legislation, in the absence of language evidencing a different purpose, is to be interpreted so as to give a uniform application to a nationwide system of taxation * * * State law may control only when the federal taxing act, by express language or necessary implication, makes its own operation dependent upon state law * * *." (Emphasis added.)

To the same effect, see *United States* v. *Gilbert Associates, Inc.*, 345 U. S. 361, 364 (1953); *Lyeth* v. *Hoey*, 305 U. S. 188, 194 (1938); *Heiner* v. *Mellon*, 304 U. S. 271, 279 (1938); *Thomas* v. *Perkins*, 301 U. S. 655, 659 (1937).

Petitioner argues that the public policy of Illinois is declared in its statutes (Pet. Br. 30). It is also found in its decisions and primarily in its Constitution. But it was held in *Gunn* v. *Dallman*, 171 F. 2d 36, 37 (C. A. 7, 1948), cert. den. 336 U. S. 937 (1949), that "the federal government's

power to tax cannot be limited by the provisions of a state constitution."

Petitioner has nowhere demonstrated any ambiguity, confusion, or uncertainty in the terms of Section 23(a) which would warrant the disallowance of the expenses for rent and salary. The wage payments made in violation of the Defense Production and Wage Stabilization Acts—upon which he strongly relies (Pet. Br. 22-23)—are clearly inappropriate to this analysis, since such expenses are denied on the strength of specific statutory authorization that provision may be made to disallow the expenses for tax purposes. Defense Production Act of 1950, Sec. 405(a), 50 U. S. C. App. Sec. 2105(a); Stabilization Act of 1942, Sec. 5(a), 50 U. S. C. App. Sec. 965(a); *Cf. Woodworth Co.* v. *Kavanaugh*, 102 F. Supp. 9 (Mich., 1952) (Pet. Br. 22), and *Pédone* v. *United States*, 151 F. Supp. 288 (Ct. Claims, 1957) (Pet. Br. 22).

His citation of numerous decisions relating to expenditures such as bribes, fines and penalties, and defense of criminal prosecutions cannot cast any light on the meaning of the statute insofar as the particular expenses here involved are concerned. In fact, as will subsequently be shown, many of the cases cited by him deny the very meaning he asserts for them when applied to expenses of rent and wages.

The sole decision cited by petitioner having any connection with the deductibility of expenses of rent and wages by one unlawfully engaged in the business of bookmaking (*Silberman* v. *Commissioner*, 44 B. T. A. 600 (1941), Pet. Br. 15) has been grossly miscited by petitioner as will be demonstrated below (*infra*, pp. 13-15).

Petitioner must demonstrate where Section 23(a) permits application of any policy other than that clearly expressed by its terms. He does not meet this obligation by reference

to Illinois law or by voluminous citation of decisions having nothing to do with expenses of rent or wages.

> "We may grant, if a policy exists, that it may be used to resolve the uncertainty of a law, but it cannot be a substitute for a law." *Fullinwider* v. *So. Pac. R. R.*, 248 U. S. 409, 412 (1919).

2. Section 23(a)(1)(A) of the Internal Revenue Code of 1939, by Its Clear and Unambiguous Terms, Requires the Allowance of the Deductions Claimed.

The Court below based its decisions in the present cases upon its prior decision in *Commissioner* v. *Doyle*, 231 F. 2d 635 (C. A. 7, 1956), a case which presented the precise issues involved here. Doyle was a bookmaker operating in Illinois and petitioner sought to disallow the deductibility of Doyle's expenses for rent and wages. The Tax Court there decided against the petitioner and the Court of Appeals affirmed. The decision is set out as an appendix to petitioner's brief here (Pet. Br. 39).

The decision in *Doyle* was simply that "The language of Section 23 is clear and unambiguous. Its application to this case requires an affirmance of the Tax Court's decision." Citing *Textile*, the Court observed that "Here is 'clear Congressional action' contrary to the Commissioner's position." 231 F. 2d 635, 636.

There can be no question about the soundness of this holding.

Section 23(a)(1)(A) provides in part as follows:

> "In computing net income there shall be allowed as deductions:
>
> (a) Expenses.
>
> (1) Trade or business expenses.
>
> (A) In general. All the ordinary and necessary expenses paid or incurred during the tax-

> able year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * * and rentals. * * *."

The literal language of this section certainly permits the deduction of the classes of expenses—wages and rent—claimed by respondents. No issue has ever been raised in these proceedings as to the amount of the deductions claimed by respondents or whether the expenses were incurred in their trade or businesses. There is no limitation of any kind with respect to the legality of the trade or business in which the expenses are incurred, nor can there be any doubt that such expenses are "ordinary and necessary" since they are specifically defined as such in the section. "The language of 23(a) contains no express reference to the lawful or unlawful character of the business expenses which are declared to be deductible." *Commissioner* v. *Heininger*, 320 U. S. 467, 474 (1943).

Because of the specific definition of the kinds of expenses here involved as being "ordinary and necessary" petitioner could scarcely contend that "ordinary and necessary" does not include them. These are not expenses such as payment on judgments for Price Control Act violations (*Lentin* v. *Commissioner*, 226 F. 2d 695 (C. A. 7, 1955)), or lobbying and propaganda expenses (*Textile Mills Securities Corp.* v. *Commissioner*, 314 U. S. 326 (1941)), or illegal rebates (*Boyle, Flagg & Seaman, Inc.*, 25 T. C. No. 8 (1955)), none of which are specifically defined as "ordinary and necessary," and hence allow for application of a general policy against their deductibility.

Neither could petitioner claim that the activities of respondents in pursuit of which these expenses were incurred are not a "business" for petitioner himself, as well as Congress (as shall be shown) recognizes that gambling—whether legal or illegal—is a business within the meaning of

Section 23(a). Thus in Revenue Ruling 54-219, Cumulative Bulletin 1954-1, p. 51, petitioner has held that the federal excise tax on wagers and the special tax paid by persons engaged in receiving wagers are deductible as ordinary and necessary business expenses under Section 23(a). This Ruling is set out as Appendix A to this brief. And in his brief in the instant case, petitioner, to avoid the admonition in *Commissioner v. Heininger*, 320 U. S. 467, 474 (1943), states he is not "contending that Congress intended to tax the gross income of one business and the net income of another." (Pet. Br. 13.) To prove his sincerity in this respect, petitioner states that "when a bookmaker buys paper or pencils, or gasoline for his car, it is not necessarily an illegal transaction." (Pet. Br. 27.) It is not readily apparent why, under petitioner's theory of public policy, even these expenditures should be permitted as deductions (see *infra*, pp. 31-32).

If further support for the plain meaning of the statute is required it is found in the legislative history of Section 23(a) and other provisions of the Code, in the various attempts of petitioner to avoid this plain meaning in prior litigation and in recent action of Congress in the taxation of the business of gambling.

3. Prior Tax Court Decisions Affirm the Plain Meaning of the Statute.

The subject of taxation and illegal gambling appears to have been first discussed by the Board of Tax Appeals in *Appeal of McKenna*, 1 B. T. A. 326 (1925). McKenna was a bookmaker operating illegally. Both he and the Commissioner raised the ultimate issue in this area. McKenna claimed he was not taxable at all and the Commissioner claimed he was taxable on his gross receipts and could not deduct amounts paid out on winning wagers, amounts re-

turned to bettors because the horse upon whom the bet had been placed did not run, and amounts bet by McKenna with other bookmakers—so-called layoff bets. Each supported his position with the same argument—the business was illegal. McKenna argued that this made his income immune from taxation and the Commissioner argued that this made his expenses unavailable to reduce that income. The Board of Tax Appeals rejected both contentions. "* * * Gambling is not an offense *malum in se* but is merely *malum prohibitum* in certain State jurisdictions. It is not even *malum prohibitum* under Federal law." 1 B. T. A. 326, 330. Thus the Board recognized what the Supreme Court has so often said—the revenue laws have as their general purpose the establishment of a uniform scheme for taxation, not subject to state control or limitation.

Nine years later, in 1934, there first appeared in the Code present Section 165(d), that "Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions." This was Section 23(h) in the 1939 Code, and Section 23(g) when it first appeared in the Revenue Act of 1934.

The House Committee Report on the 1934 Revenue Act stated with reference to the new section:

> "Existing law does not limit the deduction of losses from gambling transactions where such transactions are legal. Under the interpretation of the courts, illegal gambling losses can only be taken to the extent of the gains on such transactions. *A similar limitation on losses from legalized gambling is provided for in the bill.* Under the present law many taxpayers take deductions for gambling losses but fail to report gambling gains. This limitation will force taxpayers to report their gambling gains if they desire to deduct their gambling losses." (Emphasis added.) House Report 704, 73 Cong., 2d Sess. (1934). (Cum. Bull. 1939-1, Part 2, p. 554, 570).

It is thus apparent from the *McKenna* case and the legislative history of Section 165(d) that disbursements in connection with illegal gambling—clearly violative of many state laws—were recognized as valid deductions prior to the passage of that section, the purpose of that section being to impose the same limits on legal gambling transactions that already existed on illegal gambling transactions.

In commenting on this section, the Court of Appeals for the Fifth Circuit stated that all gambling losses could be deducted to the extent of gambling gains without regard to the legality of the transactions. "No longer need it be inquired whether the wagers were illegal so that the loss need not have been paid; nor what the state of mind of the taxpayer was as respects his purpose to win a profit." *Humphrey* v. *Commissioner*, 162 F. 2d 853, 855 (C. A. 5, 1947), cert. den. 332 U. S. 817 (1947).

This development certainly does not manifest any attitude on the part of Congress that illegal gambling was to be treated, for federal tax purposes, differently than any other business. Once *McKenna* passed the ultimate point—whether pay-outs on illegal wagers were deductible—and Congress acknowledged and codified this position in 1934, then it was inevitable that Section 23(a) should treat gambling—whether legal or illegal—as any other business.

Litigation in the Tax Court after *McKenna* confirmed the plain meaning of Section 23(a)—that ordinary and necessary expenses of an illegal gambling business were deductible, and that wages and rent were such expenses.

The first significant decision was *Israel Silberman*, 44 B. T. A. 600 (1941), cited by petitioner at page 15 of his brief. There the taxpayer operated as a "betting commissioner" at various New York race tracks, paying certain fees for the use of space and wages to clerks registering bets. New York had in effect a statute similar to that of

Section 336 of the Illinois Criminal Code, prohibiting the occupancy of premises for that purpose and prohibiting the registering of bets. The taxpayer realized no profit from his illegal operations and sought to deduct these expenditures from income from lawful sources. The decision did state that "expenditures made in the carrying on of activities which in themselves are in contravention of law and illegal have been held to be not deductible as business expenses on grounds of public policy." *Ibid.*, at 603-4. The expenses for rent and salaries in *Silberman* fell within this prohibition, said the Board, because, first, the New York Statute makes it illegal to let a booth to receive bets and to assist in the receiving and recording of bets, and—

> "Second, the petitioner in claiming deduction for these expenditures seeks to offset such expenditures against income from lawful sources received from other legal business activities, and to thereby obtain reduction of tax upon that income. *Such claim differs from a claim that the income to be taxed from an illegal business is the net income received therefrom. Cf. James P. McKenna*, 1 B. T. A. 326. In reality petitioner sustained loss from his illegal business activities and seeks deduction for part of the loss in the guise of a claim for a deduction for business expenses. Under the rule in *Mitchell M. Frey, Jr., et al., Executors, supra*, losses sustained in illegal gambling operations are not deductible." 44 B. T. A. 604. (Emphasis added.)

Further, the Board made the following finding of fact:

> "Petitioner did not realize any income or gains or profits in the taxable year from his activities in making, registering, and recording bets and wagers upon horse races *against which he could offset* the expenditures for fees and salaries at race tracks." 44 B. T. A. 601. (Emphasis added.)

It is thus apparent that the holding in *Silberman* was consistent with *McKenna* and was in conformity with the

requirements of Section 23(h) of the 1939 Code—that losses from wagering transactions could only be deducted from gains from such transactions.

Since respondents here do "claim that income to be taxed from an illegal business is the net income received therefrom" and did realize gains against which they "*could* offset the expenditures from fees and salaries" (in the words of *Silberman*) by no conceivable construction is *Silberman* any support for petitioner's position that these expenditures *cannot* be offset against such gains.

Silberman, in fact, is clear support for respondents' position that illegal gambling is a business within Section 23(a) and that the wages and rent are ordinary and necessary expenses, deductible from gross income so long as any gross income exists.

In *A. C. Stralla*, 9 T. C. 801 (1947), the operators of an illegal gambling ship claimed as deductions expenditures for fees incurred in defense of criminal actions, for penalties paid the State of California and for lobbying activities and purported "public relations services." All these deductions were disallowed. None of these expenses were clearly "ordinary and necessary" and would not be allowed as deductions in any business, legal or illegal. The Tax Court distinguished these from expenses "made in the actual production of income; deduction of expenses of that character has been allowed." 9 T. C. 801, 802.

Despite the clear distinction drawn in *Stralla* between the two kinds of expenses, it is nonetheless cited by petitioner in support of his general "public policy" argument (Pet. Br. 22). This is a clear demonstration of petitioner's technic of applying a general doctrine without regard to the particulars of the present cases, or to the particulars out of which the doctrine arose.

In *G. A. Comeaux*, 10 T. C. 201 (1948), the Commissioner

again attempted to disallow the ordinary and necessary expenses of an illegal gambling business. The taxpayer operated a "horse-book" establishment in Kansas. For the years 1938 to 1944 the Commissioner denied as deductions sums paid for protection from arrest and prosecution and salaries paid to persons engaged in operating the business, as well as other miscellaneous expenses. It was found by the Tax Court that this enterprise was illegal under the criminal statutes of Kansas. The Tax Court affirmed the Commissioner's disallowance of protection payments, but reversed his disallowance of salary and miscellaneous expenses. In pointing out the distinction, the Tax Court stated, at p. 207:

> "The second issue relates to the deduction of salaries and miscellaneous expenses, the 'legitimate expenses of an illegitimate business.' The amount of such items is not in dispute. These expenses were incurred in earning the income reported by petitioner or attributed to him by respondent. In *Anthony Cornero Stralla*, 9 T. C. 801, at 821, this Court recognized that such expenses are deductible, in contradistinction to those expenses which are not deductible because contrary to public policy. We said: 'The expenditures here in issue were not made in the actual production of the income; deduction of expenses of that character has been allowed.' The income tax law is not a tax on gross income, even if the income be earned in an illegal business. *Commissioner* v. *Heininger*, 320 U. S. 467. The deduction of such expenses depends on the innate character of the item itself. Thus the protection expenses have been disallowed as being contrary to sound public policy or proscribed types of conduct. But items not so to be characterized may be deductible. The distinction may at first seem nebulous, but it is nonetheless real. The items now under discussion are in the latter category and are allowable deductions. The amounts appear in the findings of fact."

The Commissioner did not appeal this decision, but on review of another aspect of the decision raised by the taxpayer's appeal in *Comeaux* v. *Commissioner*, 176 F. 2d 394, 400 (C. A. 10, 1949), the Court said, in passing: "The amounts are not in dispute, and it is agreed that while legitimate expenses incurred in an illegitimate business are deductible, amounts paid for protection are not legitimate business expenses. The Tax Court allowed certain claimed expenses incurred in the operation of the business * * *."

Not only did the Commissioner not appeal in *Comeaux* but he acquiesced in the Tax Court decision in that case as well as in *Stralla*. See 1948—1 Cum. Bull. pp. 1, 3. On page iv of the Internal Revenue Bulletin within which these acquiescences are found appears the following notation:

> "Notice that the Commissioner has acquiesced or non-acquiesced in a decision of the Tax Court relates only to the issue or issues decided adversely to the Government. Decisions so acquiesced in should be relied upon by officers and employees of the Bureau of Internal Revenue *as precedents in the disposition of other cases.*" (Emphasis added.).

The primary significance of *Comeaux* lies not only in the fact that it concerned salary expenses, as do the instant cases, but that the Kansas statute which prompted the Tax Court to find the taxpayer's activities illegal is identical in its operative language with Section 336 of the Illinois Criminal Code, upon which petitioner here relies. Compare Ch. 21-1510, Kan. Gen. Stats., and Ch. 38, Sec. 336, Ill. Rev. Stats. (These statutes are set out in Appendix B to this Brief.)

Subsequent to the acquiescence in *Comeaux*, and until the present cases, the policy of the Internal Revenue Department appears to have been to allow deductions for actual expenses incurred in the production of income from an illegal gambling business. Numerous Tax Court deci-

sions are found in which deductions for rent and salaries in connection with illegal gambling operations have been allowed by the Commissioner without question. See, for example, *S. W. Truman*, P-H T. C. Memo ¶ 49,027 (1949), an Ohio numbers operator allowed deductions for compensation paid to writers and "commission men"; *Mark H. Tinsley*, P-H T. C. Memo ¶ 54,225 (1954), Florida numbers operator allowed deduction for rent; *Marcus H. Hackerman*, P-H T. C. Memo ¶ 54,151 (1954), Tennessee numbers operator allowed deduction for compensation paid writers and pick-up men and wages paid employees; *Jack Lee*, P-H T. C. Memo ¶ 54,203 (1954), Alabama bookmaker allowed salary expense; *Jack Federika*, P-H T. C. Memo ¶ 55,172 (1955), Ohio bookmaker apparently allowed deductions for rent and for salary paid sheetwriters responsible for listing bets; *Louis A. Simon*, P-H T. C. Memo ¶ 55,324 (1955), Wisconsin bookmaker allowed deduction for salary and for bad debt allowance even though debts void and uncollectible by legal action.

Two other Tax Court cases decided after *Comeaux* and before the present cases are also significant, primarily because they are relied on by petitioner in support of his general theory. The first of these is *C. W. Thomas*, 16 T. C. 1417 (1951) (Pet. Br. 22). Thomas operated an illegal game in Florida known as "Bolita" during 1946 and prior years. He was indicted, tried and convicted by Florida authorities early in 1946 for these activities and was sent to the state penitentiary. He sought to deduct from his gross income for the year the attorney fees incurred in defense of the state criminal charges. In denying his contention the Tax Court stated: "The fees were not incurred in the actual production of the income of the illegal business and did not enable him to continue his gambling business," citing *Heininger*, *Stralla* and *Comeaux*. "The petitioner would reduce the cost of unsuccessfully defending

himself against a criminal charge by deducting the expense from his taxable income and thus, in effect, having the Federal Government assist in his defense. The allowance of a deduction would be against public policy. The amount is not an ordinary and necessary expense of any business regularly carried on by the taxpayer," again citing *Stralla* and *Comeaux*. *Ibid.*, 1418.

Here the Tax Court by citing *Stralla* and *Comeaux* recognized that attorney fees paid in the unsuccessful defense of a criminal suit are different from expenses incurred in the production of income, such as rent and wages.

The second decision is *Charles A. Clark*, 19 T. C. 48 (1952), where the deductibility of payments made to a California municipality to allow the taxpayer to engage in an illegal slot machine business was denied. "The payments resemble the 'protection payments' held nondeductible in *G. A. Comeaux*, 10 T. C. 201, aff'd. 176 F. 2d 394", 19 T. C. 48, 52.' The reliance of *Clark* on *Comeaux* which clearly distinguished protection payments from salary payments under a Kansas statute identical to Section 336 of the Illinois Criminal Code hardly establishes *Clark* as authority for the proposition that the rent and salary expenses in the present cases are not deductible. Yet *Clark* is cited by petitioner without drawing the distinction between expenses for protection and expenses for rent and wages (Pet. Br. 23).

The Tax Court's position in *Comeaux* was reaffirmed in its consideration of *Charles V. Doyle*, P-H T. C. Memo ¶ 54,340 (1954). There the identical issues raised in the present cases were considered by the Tax Court. Taxpayer was engaged in the unlawful business of bookmaking in Illinois. The Commissioner sought to disallow his deductions for rent and wages on the very same theory here advanced. The Tax Court held the expenses deductible on the author-

ity of *Stralla* and *Comeaux*. Thus the decision of the Seventh Circuit Court of Appeals in *Commissioner* v. *Doyle*, 231 F. 2d 635 (C. A. 7, 1956); upon which it predicated its decisions in the present cases, affirmed the Tax Court—which may seem somewhat surprising in view of the implication of petitioner's argument that the decisions below are some kind of mutant in the field of tax litigation.

In its decision in *Mesi* the Tax Court simply ignored what had been done in *Doyle* and sought to explain away *Comeaux* as "clearly distinguishable" because "the record in the instant case establishes that the payments in question constituted the illegitimate expenses of an illegitimate business, whereas no such finding of fact was made in *G. A. Comeaux*." (R. 92.) The Tax Court in *Mesi* acknowledged that both cases involved the deductibility of wages paid to employees in an illegal bookmaking establishment (R. 92). The Tax Court in *Comeaux* found the business to be illegal under Kansas Statutes. The relevant Kansas and Illinois statutes are identical. Under these circumstances the "clear" distinction between *Mesi* and *Comeaux* appears to be that in one the deduction was allowed and in the other it was not. The Tax Court in *Mesi* simply accepted petitioner's "public policy" argument without question and disregarded completely and without explanation the language of Section 23(a). It recognized that "the disallowance of the instant expenditure may be almost tantamount to taxing petitioner on his gross rather than his net income." This was apparently all right in the Tax Court's view, because "it is axiomatic that deductions are a matter of legislative grace." (R. 93.) However, the Tax Court gave no clue as to why it thought the legislative grace had not been bestowed by the plain terms of the statute. The reversal of that decision on the authority of the statute by the Court below was manifestly correct.

4. Petitioner's Theory That Deductions Under Section 23(a) Are Dependent Upon State Law Is Refuted by Legislative History, and If Adopted Would Cast Doubt Upon the Constitutionality of the Statute.

Thus up until the Tax Court decisions in the present cases, the Commissioner and Tax Court followed a practice consistent with the ruling in *Comeaux* and the acquiescence in that decision, and applied Section 23(a) exactly as it was written. In the taxation of gambling enterprises, unlawful under state law, the enterprise was treated no differently than a lawful business and ordinary and necessary expenses such as wages, rent and telephone were allowed, and expenses not ordinary or necessary, such as protection payments, bribes, or fees for unsuccessful defense of criminal actions, were not allowed.

The plain language of the statute which appears to draw no distinction between lawful and unlawful business or between lawful and unlawful expenses is clearly supported by legislative history respecting illegal gambling. The issue first arose during consideration of the Revenue Act of 1913. Section II (A) and (G) (b) of that act provided for the deduction of "necessary expenses actually paid in carrying on a business" including a provision for the deduction of "losses actually sustained during the year, incurred in trade." During debate on the section, which was the prototype of Section 23(a), question was raised about illegal or illegitimate trade and an amendment was offered to add the qualifying words "ordinary and legitimate" before the word "trade". The amendment was rejected. 50 Cong. Rec. 3850.

During the course of the debate on this subject, the purpose of the bill was explained by Senator Williams, a member of the Finance Committee and in charge of the income tax provisions of the bill:

"* * * The object of this bill is to tax a man's net in-

come; that is to say, what he has at the end of the year after deducting from his receipts his expenditures or losses. It is not to reform men's moral characters; that is not the object of the bill at all. The tax is not levied for the purpose of restraining people from betting on horse races or upon 'futures', but the tax is framed for the purpose of making a man pay upon his net income, his actual profit during the year. The law does not care where he got it from, so far as the tax is concerned, although the law may very properly care in another way." 50 Cong. Rec. 3849.

Reference has already been made to the development of the section of the Internal Revenue Code providing that "losses from wagering shall be allowed only to the extent of the gains from such transactions." Sec. 23(h), Internal Revenue Code of 1939; Section 23(g), Revenue Act of 1934. As has been shown, the purpose of this section was to place legal and illegal gambling on the same basis (*supra*, pp. 12-13).

This Congressional attitude toward gambling was reaffirmed during consideration of the Revenue Act of 1951. It was in this Act that first appeared the 10% excise tax on gross receipts from wagering, Section 3285, Internal Revenue Code of 1951, and the $50 special occupation tax and registration requirement for all persons engaged in the business of wagering, Sections 3290 and 3291, of Internal Revenue Code of 1951 (Sections 4401-5, 4411-14, Internal Revenue Code of 1954). These measures were adopted in the wake of the activities of the Special Senate Committee to Investigate Organized Crime in Interstate Commerce, and one of the admitted objects of the tax and the registration requirements was to inhibit the business of gambling. See *United States* v. *Kahriger*, 345 U. S. 22, 27, 35 (1953), upholding its constitutionality.

The Senate and House Reports on the 1951 Revenue bill both made it abundantly clear that there was no question

but that illegal gambling was a business subject to the income tax on the same basis as other business. Thus both reports state:

> "Since its inception, the Federal income tax has applied without distinction to income from illegal as well as legal sources, and it has never been generally supposed that such application carried with it any implied authorization to carry on illegal activities. Moreover, in the field of excise taxes the tax on coin-operated gambling devices has been applied without regard to whether or not the operation of a particular machine is in violation of State or local law." House Report No. 586, p. 55; Senate Report No. 781, p. 113, 82d Cong. 1st Sess. (1951).

This was reaffirmation of the statement by the Court of Appeals for the Seventh Circuit when *Heininger* was before it, *Heininger* v. *Commissioner*, 133 F. 2d 567 (C. A. 7, 1943), aff'd. 320 U. S. 467 (1943), that no distinction has been made by Congress or the Bureau of Internal Revenue between income from legal or illegal business. "Both, so far as the statutes and regulations of the Department went, were to be taxed on their net income." This decision was written by Judge Minton, who was a member of the Senate when the Revenue Act of 1939 was adopted. He pointed out that although this lack of distinction between legal and illegal business was well known to Congress, no change had been made in the law. He stated:

> "If this change is to be made and the policy altered, *let Congress do it.* Congress would need only to add the word 'legal' before the word 'trade' in the third line of Section 23 (a)(1).
>
> We are asked, in the guise of construing the words 'ordinary and necessary', to amend the statute. In other words, to engage in a little judicial legislation. We decline the invitation." 133 F. 2d 567, 570. (Emphasis added.)

Congress itself was asked to make this change and it, too, declined the invitation in 1951. The following is found on the final page of the Senate Report No. 781, p. 120, 82 Cong., 1st Sess. (1951):

> "Tax Treatment of Illegal Activities."
>
> "Several amendments have been proposed to the committee which would affect the tax treatment of gamblers and other persons who receive income from illegal sources. In summary, these amendments would—
>
> (a) Disallow as a deduction from gross income any expenses incurred in illegal wagering and any losses resulting from illegal wagering;
>
> * * * * *
>
> Your Committee believes that additional time is necessary for detailed study of these suggestions and therefore believes that action on them should not be taken at this time. The Committee is fully aware of the importance of a strict enforcement of the income tax laws in this area."

Petitioner attempts to minimize the impact of the refusal by Congress to amend Section 23(a) in 1951, because he says this indicates no intention with respect to the deductibility of payments in themselves illegal. This assumes that there is something unique about expenses for rent and wages not shared by other expenses of an unlawful gambling business (see *infra*, pp. 29-36). It also assumes complete ignorance on the part of Congress of the existence of the Tax Court's decision in *Comeaux*, its affirmance by the Court of Appeals, and the acquiescence by the Commissioner in that decision, and his uniform following of that acquiescence up to that time. In view of the preoccupation of Congress with the question of the taxation of gambling enterprises this assumption is wholly unwarranted.

Clearly indicative of the mood of Congress toward the issue are the debates on the proposal to disallow as a deduction from gross income any expenses incurred in illegal wagering. The amendment was offered by Senator Kefauver, who wanted to eliminate the 10% excise tax and the $50 special tax. 97 Cong. Rec. 12230-31.

Each side to the debate charged that the proposal of the other would interject the Internal Revenue Bureau into purely local matters. Senator Kefauver, in attacking the excise and special tax, quoted from an editorial which had appeared in the Washington *Star*. The editorial observed that it had been said that the Bureau had estimated it would need 3,000 additional agents to enforce the excise and special tax. Senator Kefauver said he thought it would require, not 3,000, but 30,000 to 40,000 men. He then quoted:

> "Such a force would be encroaching on a field hitherto reserved for local law enforcement agencies. Its job would be, first, to determine whether a suspected evader of the gambling taxes actually was engaged in gambling and, second, what his income from that source amounted to. Local police undoubtedly would welcome the invasion of Federal agents into this field, for it would tend to relieve police of a responsibility rightfully theirs.
>
> "But the Internal Revenue Bureau never was intended to become a crime suppression agency * * *." 97 Cong. Rec. 12238.

The chief spokesman against Senator Kefauver's proposal was Senator Johnson, a member of the Finance Committee which sponsored the excise and special taxes. In support of the committee bill he said:

> "Just as the proposed tax does not in any way give Federal authorization to illegal gambling, the bill likewise does not in any way contemplate that the Federal Government will take over the enforcement of

> State and local anti-gambling laws. The primary purpose of the committee's amendment is to raise revenue not to encroach in a field which is fundamentally a local responsibility. We are dealing with a tax bill, not with the criminal code." 97 Cong. Rec. 12238.

Senator Johnson then inserted in the Congressional Record a statement relating to Senator Kefauver's proposals. "Under present law," observed Senator Johnson, "wagering expenses are deductible if they are business expenses." 97 Cong. Rec. 12239.

He raised three primary objections to changing this. First, the distinction for tax purposes between income from legal and illegal sources raised by Senator Kefauver's proposal to prohibit the deduction of the expenses of an illegal gambling enterprise raised serious constitutional issues under *United States* v. *Constantine*, 296 U. S. 287 (1935), because the tax appeared to be a penal rather than a revenue measure. Second, the question was raised as to what law would be looked to to determine illegality. Presumably, concluded Senator Johnson, it would be to the law of a state, and where local option existed, to county and municipal ordinances. "It is suggested that the Federal tax laws should not be made dependent upon the laws of such varied, non-federal jurisdictions," he concluded on this point. 97 Cong. Rec. 12240.

Finally, with respect to the interjection of the Federal government into state matters, he stated:

> "Assuming, however, that the laws of other jurisdictions can be made the basis of the application of the Federal tax laws, the question then arises as to whether a conviction for a violation of some anti-gambling statute will be a prerequisite to the disallowance of gambling losses and expenses, or is it intended that the Federal tax authorities are to have the power to make a conclusive and presumptive determination of the legality or illegality of any par-

> ticular transaction without regard to any judicial determination? If the latter is intended to be the case, it is suggested that this is a wider and more arbitrary authority than has ever been granted in the field of tax collection. On the other hand, if a conviction of a violation of State or local law is intended to be required, then it is suggested either that the proposed amendment will be administratively impractical, or that the Bureau of Internal Revenue will have to associate itself in the enforcement of State and local laws." 97 Cong. Rec. 12240.

Senator Kefauver's proposal was thereupon defeated. 97 Cong. Rec. 12244.

If this was the attitude of the Senate toward making Federal taxation dependent on state law and on associating the Internal Revenue Bureau with local criminal law enforcement, then how much more contrary to this view is the theory advanced by petitioner that taxability should not depend on the legality of the business (as Senator Kefauver proposed), but on the legality of each item of expense? How much more arbitrary for the Tax Court to attempt to decide whether rent or wages, or countless other items of expense, are illegal under Illinois law, while expenses for paper and pencils are not (Pet. Br. 27). Thus even assuming that petitioner's theory of "independently illegal" expenses (Pet. Br. 26), can withstand close scrutiny (see *infra*, pp. 29-36) nonetheless it is clear that such a theory of taxation is at violent odds with what Congress believes to be the proper constitutional basis for a revenue statute. If the Senate could not accept Senator Kefauver's proposal, which at least would have required only one determination of state law (the illegality of the business), it certainly must be concluded that Section 23(a) does not countenance petitioner's theory, even assuming the theory makes any sense at all.

By asking that Section 23(a) be construed so as to allow or disallow deductions based on their legality or illegality under state law, petitioner is asking this Court to place an unconstitutional construction upon an otherwise valid statute. In *United States* v. *Kahriger*, 345 U. S. 22 (1953), the constitutionality of the special occupational tax on those engaged in gambling was upheld, and the tax was distinguished from the tax held invalid in *United States* v. *Constantine*, 296 U. S. 287 (1935), because:

> "The tax in the *Constantine* case was a special additional excise tax of $1,000.00 placed only on persons who carried on a liquor business in violation of state law. The wagering tax with which we are here concerned applies to all persons engaged in the business of receiving wagers, regardless of whether such activity violates state law." 345 U. S. 22, 26.

The Court's reluctance to place a construction upon a statute which would raise serious constitutional doubts is pointed up by *United States* v. *Calamaro*, 354 U. S. 351 (1957). There an effort was made to apply the special occupational tax to a so-called "pick-up" man in a "numbers game" operating illegally in Pennsylvania. (Cf. the opinion in the Court of Appeals, 236 F. 2d 182 (C. A. 3, 1956) for a discussion of the illegal nature of the activities of the "pick-up" man.)

In commenting on the government's argument that the "pick-up" man was a person "engaged in receiving wagers for or on behalf of any person" within the meaning of the statute, the Court stated:

> "The fact remains, however, that Congress did not choose to subject all employees of gambling enterprises to the tax and reporting requirements, but was content to impose them on persons actually 'engaged in receiving wagers.' *Neither we nor the Commissioner are authorized to rewrite the statute simply because*

we may feel that the scheme it creates could be improved upon.

"We can give no weight to the Government's suggestion that holding the pick-up man to be not subject to this tax will defeat the policy of the statute because its enactment was 'in part motivated by a congressional desire to suppress wagering.' The statute was passed, and its constitutionality was upheld, as a revenue measure, *United States* v. *Kahriger*, 345 U. S. 22, and, apart from all else, in construing it *we would not be justified in resorting to collateral motives or effects which, standing apart from the federal taxing power, might place the constitutionality of the statute in doubt.*" 354 U. S. 351, 357-58. (Emphasis added.)

5. Petitioner's Theory of "Independently Illegal" Expenses Is Not Supported by State Law.

Petitioner seeks to avoid the impact of prior Congressional and judicial teaching that the Internal Revenue statutes draw no distinction between income from legal and illegal sources, and that, in Senator Johnson's words, "wagering expenses are deductible if they are business expenses." Petitioner argues that he is not here concerned with the fact that respondents were engaged in an illegal business but that the expenses of wages and rent were themselves made to induce other illegal acts. These other illegal acts were that a landlord leased to respondents space within which to conduct their illegal business and that employees recorded wagers in the course of their employment in respondents' business. The expenditures are "independently illegal" and petitioner seeks to deny them for that reason, "not because the taxpayers are engaged in illegal activities" (Pet. Br. 26, 27).

As respondents have pointed out above, even assuming these expenses were "independently illegal," petitioner must first show a statutory ambiguity permitting the ap-

plication of a policy denying the deduction of expenses otherwise clearly ordinary and necessary. Respondents have also shown that the reasons for the rejection by Congress of a proposal to deny the deduction of all expenses incurred in illegal gambling apply with even greater force to petitioner's theory of "independently illegal" expenses.

However, the fact is that the theory is really a variant of and is dependent upon the "illegal business" theory expressly rejected by Congress.

In a passage which clearly reveals the fallacies in petitioner's "public policy" and "independently illegal" expense arguments, he states:

> "We emphasize at the outset that this case does not involve a type of expenditure which would be any more deductible if it were made by a taxpayer engaged in a lawful rather than an unlawful business. Nor are we contending that Congress intended to tax the gross income of one business and the net income of another. Rather, the expenditures here—being illegal in themselves and, in fact, payments for the commission of crimes—would not be deductible by a taxpayer engaged in a legitimate business" (Pet. Br. 13).

This passage makes sense only if one completely ignores the fact that the expenditures about which petitioner is writing are for wages and rent. It is utterly impossible to conceive of this argument being made in connection with a lawful business. If these expenses are illegal it is *because* of the business, not despite it. Respondents could hardly be charged by petitioner with inducing their landlord to lease premises to them for an unlawful purpose if the business were not unlawful. Nor could they be charged with aiding and abetting their employees to record wagers in violation of the Illinois statutes if respondents' business were not in violation of the Illinois statutes. The argument may seem superficially plausible because respondents

were in fact engaged in an unlawful business, but here the circle has come full, for petitioner premises his argument on the fact that no distinction is made by him because respondents were engaged in an illegal business.

If these expenses of wages and rent should not be allowed as deductions because respondents aided and abetted the landlord or employees in committing a crime, then why should respondents be allowed a deduction for expenses incurred for inducing others to become aiders and abettors in their crime of carrying on illegal gambling? If respondents aided and abetted their employees and landlord, did not they likewise aid and abet the furnishers of their wire service, who themselves aided and abetted respondents? The furnishers of this service "which gives information over a loud speaker such as the time when the race commenced, the progress of the race until it ended, the result, and then the odds payable at the track to the winners" (R. 8) were certainly aiders and abettors in respondents' operations? The printer and supplier of safety tickets (R. 8) or 20-line sheets (R. 83-4) or hard cards (R. 8, 83), used in the illegal business, aided and abetted respondents, and respondents in turn must have aided and abetted them. But respondents were principals in all their expenditures, not merely aiders and abettors in some. It is not apparent on what theory petitioner would treat respondents more favorably when they are principals than when they are only aiders and abettors.

There is certainly no consistency in petitioner's regard for Illinois "public policy" when he recognizes as ordinary and necessary expenses the federal excise tax on wagers and the special occupation tax on persons engaged in gambling. It is of course conceivable that persons pay the $50 special tax without intending to then proceed to engage in an unlawful business, but the excise tax can only have been generated out of illegal activities.

Respondents do not contend that any crime under Illinois law is committed by the federal government in collecting either the excise tax or special tax, but Illinois "public policy" does not seem to be any less frustrated by allowing taxpayers engaged in unlawful businesses to deduct these expenses but not allowing them to deduct rent and wage expenses.

It is the height of sophistry to permit a deduction of rent by a bookmaker if he conceals from his landlord the unlawful use of the premises but to deny the deduction if the landlord was advised of the purpose, and then to allow a deduction for excise taxes paid on gross receipts from the unlawful busines where the recipient knows how the gross receipts were produced. The inevitable logic of petitioner's position is to impose a gross income tax on persons engaged in illegal gambling activities. But this result has been expressly rejected by Congress. Petitioner's position is no less contrary to the Congressional purpose because he travels only part way toward the goal to which his logic leads.

If petitioner is correct, then the Commissioner, and presumably the Tax Court, and successive reviewing courts, would have to determine whether those dealing with a taxpayer in an illegal business were, themselves thereby engaging in illegal activities. If only the taxpayers were illegally involved, then presumably the expenditure would be within Section 23(a). If the recipient of the expenditure were also involved in taxpayer's illegalities, then presumably, under petitioner's theory, the expenditure would not be allowed. Since the Commissioner and Tax Court would by hypothesis be applying local law, then local decisions interpreting the statutes and relationships would be relevant. Thus, it might be necessary to determine if the landlord in the Ross-Sullivan enterprise in-

sisted that the tenants carry on their illegal business, and not merely tolerated it.

In *McKeown Bros. Co. v. Ogden Kennel Club*, 269 Ill. App. 622 (1933), it was contended that lien claimants should be denied relief because their claim arose out of the construction of a dog track, including structures for pari-mutuel betting. Since gambling on dog racing is contrary to Illinois law, and since the claimants knew the purpose for which they were erecting the structures, it was contended the liens were invalid as contrary to Illinois "public policy." In denying this argument and holding the liens valid, the Illinois court relied on an earlier Illinois Supreme Court case, *Hoefeld v. Ozello*, 290 Ill. 147 (1919).

The issue in the *Hoefeld* case was the legality of a lease which permitted the lessee to terminate in the event the State Sunday-closing law was generally enforced. The argument was made that the landlord had knowledge that the lessee intended an unlawful use of the premises. In denying this claim, the Illinois Supreme Court cited the following with approval:

> "Although the lessor may have had knowledge that the premises would be used for an immoral purpose, unless, coupled with that knowledge, there was an intention on his part when he executed the lease that the premises should be used for such immoral purpose, the lease contract would not be void. * * * The lessor is not the keeper of the conscience of the lessee and has no police control over him in such matters, and mere knowledge on the lessor's part that the lessee is going to use the premises for an unlawful purpose does not make the lessor a participant in that purpose, for mere knowledge that the lessee may or will use the premises for an unlawful purpose is not, of itself, sufficient to show that the lessor intended that they must or shall be so used." 290 Ill. 147, 150.

Whether this decision would have any effect upon a criminal prosecution against a landlord under Section 336 of the Illinois Criminal Code does not seem to have been argued in the Illinois courts. But it could well be urged that Section 336 must be interpreted in light of that decision, and that the mere finding that the landlord "knowingly permitted these rooms to be used for the purposes of bookmaking" (R. 11) is not a crime under Section 336.

This argument is valid not only because of the implication of the *Hoefeld* decision but because of *People* v. *Viskniskki*, 155 Ill. App. 292 (1910), a criminal action against a landlord for knowingly renting premises to be used for a gaming house. The Court, in finding one of the instructions erroneous, stated that it was not an offense for the landlord to suffer or permit occupancy to continue for the balance of the lease term when he first had knowledge of its unlawful use after the term commenced. Section 336 does not speak in terms of "knowingly rent" but rather "knowingly permitting," but the result would appear to be the same.

In this connection it should be noted that the Tax Court in its decision in *Ross-Sullivan*, stated that it was clear that the lessor was "fully aware that an illegal bookmaking enterprise was being carried on upon the premises" (Pet. Br. 15), and not that lessor knew at the time of leasing that such enterprise would be carried on.

The problem inherent in petitioner's efforts to determine questions of Illinois criminal law through the expedient of Tax Court findings is further illuminated by a passing footnote reference he makes to the Illinois Conspiracy statutes. "Moreover, in making the payments of rent and wages and thus inducing the payees to violate Section 336 of the Criminal Code of Illinois, the taxpayers also

appear to have been conspirators within the meaning of Sections 139 and 140 of the Illinois Revised Statutes (1945), c. 38 (Criminal Code)." (Pet. Br. p. 29, fn. 14.) In *People* v. *Dorman*, 415 Ill. 385 (1953) it was held that an indictment under Section 139 charging a conspiracy to violate Section 336 did not lie, the Court stating:

> "We hold that the legislature did not intend the conspiracy statute to include bookmaking. Neither does there appear to be any authority to support a finding that conspiracy to keep a book was an indictable offense at common law. In *People* v. *Monroe*, 349 Ill. 270, it is stated that 'betting on horses is not *malum in se* but it is only *malum prohibitum*.'" 415 Ill. 385, 389.

These considerations of Illinois law may appear somewhat esoteric in determining the impact of a federal taxing statute. But if the petitioner is going to make the federal law dependent upon state criminal law, taxpayers ought to be able to raise whatever arguments they might raise in a state criminal proceeding. It is rather apparent that it was precisely this kind of situation that Senator Johnson correctly anticipated might arise if federal revenue laws were related to the legality or illegality of transactions under state or municipal laws. The assumption of power by the Tax Court to make these kinds of determinations of state criminal law is clearly inconsistent with the refusal by Congress to grant the power requested for the Treasury Department by Senator Kefauver in 1951.

That petitioner is really interested in striking down respondents' expenditures because of the illegal nature of the business, rather than because of any inherent characteristic of the expense involved, is made clear by his treatment of the taxpayer in *Tank Truck Rentals, Inc.* v. *Commissioner*, 243 F. 2d 14 (C. A. 3, 1957), pending on writ of certiorari No. 109. The issue in that case is the deductibility by taxpayer of fines imposed on its drivers

by Pennsylvania and other states for driving overloaded trucks. Here there would be no need to speculate on whether wages paid by taxpayers to these drivers induced the commission of an illegal act, since the fines against the drivers clearly attest to that fact. Nor would there be any need to speculate on whether taxpayer was an aider—or—abettor within the meaning of the Pennsylvania statute that "every person who shall counsel, aid or abet the commission of any misdemeanor punishable under any act of Assembly for whom no punishment is provided, shall be liable to be proceeded against and punished as the principal offender." Purdon Pa. Stats., Title 18, Sec. 5105. For taxpayer in *Tank Truck* admits the trucks were intentionally overloaded, and in fact argues that they had to be for the business to operate profitably. Yet despite these factors the strong public policy which overwhelms petitioner in the instant cases never seems to have occurred to him in *Tank Trunk Rentals*, for wages there paid to individual drivers to violate the state laws are unquestioned. (Cf. Brief for Tank Truck Rentals, in No. 109, p. 40.)

The distinction between the two situations is only that here taxpayers have been engaged in illegal gambling, not that there is anything unique about their rent and salary expenses.

6. Petitioner Has Attempted to Usurp the Legislative Function, and Hence Has Acted Beyond the Scope of His Authority.

The effort of the petitioner to accomplish by administrative practice what Congress has refused to do by statutory amendment is an effort to usurp the legislative function. Attempts in the past by the Commissioner and other administrative officials to act in derogation of the statutes

they administer have been uniformly rebuffed. The supremacy of the Congressional power in this area was recognized in *Marquette Cement Mfg. Co.* v. *Federal Trade Commission*, 147 F. 2d 589, 592-93 (C. A. 7, 1945): "Congress is the creator of all inferior federal courts, as well as administrative agencies. The jurisdiction and authority of each is confined solely to that which Congress bestows. There are no limitations upon this congressional power other than the Constitution."

In *Federal Communications Commission* v. *American Broadcasting Co.*, 347 U. S. 284 (1954), the efforts of the F. C. C. to extend its own powers to accomplish an end which it considered socially desirable were reviewed by this Court. There the F. C. C. adopted regulations providing for the denial of licenses to radio and television stations broadcasting "give-away" programs. In affirming the judgment of the district court in restraining the enforcement of these regulations, the Court succinctly summarized the issue:

> "It is apparent that these so-called 'give-away' programs have long been a matter of concern to the Federal Communications Commission; that it believes these programs to be the old lottery evil under a new guise, and that they should be struck down as illegal devices appealing to cupidity and the gambling spirit. It unsuccessfully sought to have the Department of Justice take criminal action against them. Likewise, without success, it urged Congress to amend the law to specifically prohibit them. The Commission now seeks to accomplish the same result through agency regulations. In doing so, the Commission has overstepped the boundaries of interpretation and hence has exceeded its rule-making power. Regardless of the doubts held by the Commission and others as to the social value of the programs here under consideration, such administrative expansion of § 1304 does not provide the remedy." 347 U. S. 284, 296-97.

In *Western Union* v. *Lenroot*, 323 U. S. 490, 508-9 (1945), the Court stated: "To translate this Act by a process of interpretation into an equivalent of the bills Congress rejected is, we think, beyond the fair range of interpretation. Declining that, we cannot sustain the Government's bill of complaint."

See also *United States* v. *Halseth*, 342 U. S. 277, 281 (1952).

The administrators of the tax statutes occupy no higher position with respect to Congress than do other administrators.

Thus in *Manhattan General Equipment Co.* v. *Commissioner*, 297 U. S. 129, 134 (1936), it was said concerning the administration of the tax laws:

> "The power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations to that end is not the power to make law—for no such power can be delegated by Congress—but the power to adopt regulations to carry into effect the will of Congress as expressed by statute. A regulation which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity."

See also *Koshland* v. *Helvering*, 298 U. S. 441, 446-47 (1936); *Helvering* v. *Powers*, 293 U. S. 214, 224 (1934); *United States* v. *200 Barrels of Whiskey*, 95 U. S. 571, 576 (1877).

Petitioner's motivation in deviating from the *Comeaux* doctrine, impliedly approved by Congress when it refused to adopt Senator Kefauver's suggestions in 1951, appears to have been the urging of the Attorney General who announced in a speech that he was promised the co-operation of the Treasury Department in a program to disallow all deductions for expenses incurred in illegal gambling operations as not being "ordinary and necessary." Vol. 78,

Reports of the American Bar Assn., (1953), p. 338. (See Paul, The Use of Public Policy by the Commissioner in Disallowing Deductions, U. of So. Cal. School of Law Tax Institute (1954), p. 715, for a criticism of this speech and the "public policy" doctrine.) Petitioner is obviously aware of the difficulties of an approach as unsubtle as that suggested by the Attorney General in the light of the clear statutory statement and announced Congressional intent, so he has evolved the theory of "independently illegal" expenses, no less objectionable than the Attorney General's theory of "illegal business."

It is apparent that petitioner is using the position of authority entrusted to him to impose his notions of morality and social justice upon respondents through arbitrary use of the taxing power. Such a use of power was commented upon by Justice Jackson in his concurring opinion in the decision upholding the constitutionality of the 1954 wagering tax. He considered that legislation to be a plan to tax out of existence the professional gambler, and stated:

> "It will be a sad day for the revenues if the good will of the people toward their tax system is frittered away in efforts to accomplish by taxation moral reforms that cannot be accomplished by direct legislation. But the evil that can come from this statute will probably soon make itself manifest to Congress. The evil of a judicial decision impairing the legitimate taxing power by extreme constitutional interpretations might not be transient." (*United States* v. *Kahriger*, 345 U. S. 22, 36 (1953).)

Much greater by far is the evil implicit in the arbitrary action of the petitioner here in flouting the express mandate of Congress to accomplish what he thinks are desirable moral reforms. The Attorney General does not display a keen awareness of the significance of constitutional processes when he requests that the federal revenue system be administered in this manner.

"Statutes should be construed, as far as possible, so that those subject to their control may, by reference to their terms, ascertain the measure of their duty and obligation, rather than that such measure should be dependent upon the discretion of executive officers, to the end that ours may continue to be a Government of written laws rather than one of official grace." *United States* v. *Northern Pacific Ry. Co.*, 242 U. S. 190, 195 (1916).

CONCLUSION.

For the foregoing reasons, the judgments of the Court below should be affirmed.

Respectfully submitted,

E. J. Blair,
Eugene Bernstein,
77 W. Washington Street,
Chicago 2, Illinois,
Attorneys for Neil Sullivan, Grace Sullivan, James Ross and Ann Ross.

Howard R. Slater,
77 W. Washington Street,
Chicago 2, Illinois,
Attorney for Sam Mesi.

APPENDIX A.

Revenue Ruling 54-219, Internal Revenue Cumulative Bulletin 1954-1, page 51.

"Regulations 118, Section 39.23(a)-1: Rev. Rul. 54-219 Business Expenses.

"The Federal excise tax on wagers under section 3285(d) of the Internal Revenue Code and the special tax under section 3290 of the Code paid by persons engaged in receiving wagers are deductible, for Federal income tax purposes, as ordinary and necessary business expenses under section 23(a) of the Internal Revenue Code, provided the taxpayer is engaged in the business of accepting wagers or conducting wagering pools or lotteries, or is engaged in receiving wagers for or on behalf of any person liable for the tax under sections 3285(d) of the Code."

APPENDIX B.

Illinois' Revised Statutes.

Chapter 38, Criminal Code of State of Illinois:

"336. Book-making and pool-selling unlawful.

§ 1. *Be it enacted by the People of the State of Illinois, represented in the General Assembly:* That any person who keeps any room, shed, tenement, tent, booth, or building, or any part thereof, or who occupies any place upon any public or private grounds within this state, with any book, instrument or device for the purpose of recording or registering bets or wagers, or of selling pools, or any person who records or registers bets or wagers, or sells pools upon the result of any trial or contest of skill, speed or power of endurance of man or beast, or upon the result of any political nomination, appointment or election, or being the owner, lessee or occupant of any room, shed, tenement, tent, booth, or building, or part thereof, knowingly permits the same to be used or occupied for any of these purposes, or therein keeps, exhibits or employs any device or apparatus for the purpose of recording or registering such bets or wagers, or selling of such pools, or becomes the custodian or depository for hire or privilege, of any money, property, or thing of value staked, wagered or pledged upon any such result, shall be punishable by imprisonment in the county jail for a period not longer than one year, or by fine not exceeding $2,000 or both. Provided, however, that the provisions of this act shall not apply to the actual enclosure of fair or race track associations that are incorporated under the laws of this state, during the actual time of the meetings of said associations, or within twenty-four hours before any such meetings."

Kansas General Statutes:

"Ch. 21, Par. 21-1510.

"*Bookmaking or selling pools, or permitting on premises; penalty.* That any person who keeps any room, shed, tenement, booth or building, or any part thereof, or who occupies any place upon any public or private grounds within this state with any book, instrument or device for the purpose of recording or registering bets or wagers or selling pools, upon the result of any trial or contest of skill, speed or power of endurance of man or beast which is to be made to take place within or beyond the limits of this state, except within the inclosure of a race track and upon races or trials of speed being conducted within said inclosure (provided that the exception herein shall not apply to any race track or inclosure for more than two weeks in any one year), or any person who records or registers bets or wagers, or sells pools upon the result of any trial or contest of skill, speed or power of endurance of man or beast, which is to be made or take place within or beyond this state, or upon the results of any political nomination, appointment or election which is to be made or held either within or beyond the limits of this state, or being the owner, lessee or occupant of any room, shed, tenement, booth or building, or part thereof, knowingly permits the same to be used or occupied for any of the purposes hereinbefore prohibited, or therein keeps, exhibits or employs any device or apparatus for the purpose of registering such bets or wagers, or selling pools, as are hereinbefore prohibited, or becomes the custodian or depositary for hire or privilege of any money, property or thing of value which is staked, wagered or pledged contrary to the provisions of this act, shall be guilty of a misdemeanor, and on conviction shall be punished by imprisonment in the county jail for a period of one year and by a fine of one thousand dollars."